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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 40

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

THE OHIO LEATHER COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 5, 1942
CERTIORARI GRANTED APRIL 6, 1942

SUPREME COURT OF THE UNITED STATES

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1 Before United States Board of Tax Appeals

Docket No. 96420

THE OHIO LEATHER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

APPEARANCES

For Petitioner: Donald J. Lynn, Esq., H. A. Mihills, Esq.
For Respondent: T. H. Callahan, Esq.

Docket entries

1938

Dec. 12—Petition received and filed. Taxpayer notified. (Fee Paid.)
Dec. 13—Copy of petition served on General Counsel.
Dec. 12—Request for Circuit hearing in Cleveland, Ohio, filed by taxpayer. 12/13/38 copy served.

1939

Jan. 13—Praecipe for appearance of Donald J. Lynn as counsel for petitioner, filed.
Feb. 1—Answer filed by General Counsel.
Feb. 4—Copy of answer served on taxpayer. Cleveland, Ohio, calendar.
Aug. 31—Hearing set Oct. 23, 1939, in Cleveland, Ohio.
Oct. 23—Hearing had before Mr. Opper, Division 14, on the merits. Submitted. Stipulation of facts filed. Briefs due Dec. 7, 1939—replies due 12/22/39.
2 Nov. 2—Transcript of hearing 10/23/39 filed.
Dec. 7—Motion for extension of 20 days to file brief filed by taxpayer. 12/7/39 granted.
Dec. 7—Brief filed by General Counsel.
Dec. 29—Motion for extension to Jan. 17, 1940, to file brief filed by taxpayer. 1/2/40 granted.

1940

Jan. 17—Brief filed by taxpayer. 1/17/40 copy served.
Feb. 15—Motion for leave to file reply brief filed by taxpayer—reply brief lodged. 2/19/40 granted.
June 13—Memorandum opinion rendered—Mr. Opper, Division 14. Decision will be entered under Rule 50.
July 1—Agreed computation of deficiency filed.
July 3—Decision entered—Clarence V. Opper, Division 14.

1940
Sept. 21—Petition for review by U. S. Circuit Court of Appeals, Sixth Circuit, with assignments of error filed by General Counsel.
Sept. 26—Proof of service filed (counsel).
Sept. 27—Proof of service filed by General Counsel (taxpayer).
Oct. 14—Motion for extension to 12/20/40 to complete and transmit record filed by General Counsel.
Oct. 14—Order enlarging time to Dec. 20, 1940, to prepare and deliver record entered.
Nov. 20—Statement of points filed by General Counsel—proof of service thereon.
Nov. 20—Designation of portions of record filed by General Counsel with proof of service thereon.

3 Before United States Board of Tax Appeals

Petition

Filed December 12, 1938

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency dated September 12, 1938 and as a basis of its proceedings alleges as follows:

1. The petitioner is a corporation organized under the laws of the State of Ohio and having its principal office at 1052 North State Street, Girard, Ohio. The return for the period here involved was filed with the Collector for the eighteenth district of Ohio.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on September 12, 1938.

3. The amount of alleged deficiency covering income and undistributed profits tax for the calendar year 1936 is $3,858.92 and the amount of tax in controversy is $3,680.31.

4. The determination of tax set forth in the said notice of deficiency is based upon the following error:

(a) In computing the surtax on undistributed profits, respondent has failed to allow as a credit against adjusted net income, the amount of $20,949.36, representing an amount equal to ten percent of the earnings and profits of the petitioner for the taxable year which the petitioner paid during the taxable year and which was required (by a provision of a written contract executed by petitioner prior to May 1, 1936, which provision ex-

pressly deals with the disposition of earnings and profits of the taxable year) to be irrevocably set aside and paid for the discharge of a debt.

5. The facts upon which petitioner relies as a basis for its appeal are as follows:

(a) The petitioner is a corporation organized under the laws of the State of Ohio and filed its income tax return for the calendar year 1936 with the Collector for the eighteenth district of Ohio.

4 (b) Under the provisions of a Trust Indenture executed by the petitioner prior to May 1, 1936, ten percent of the net earnings of the petitioner (as defined by said Trust Indenture) for the calendar year 1936 were required to be paid by the petitioner for the discharge of a debt.

(c) On December 16, 1936 and in compliance with the provisions of the Trust Indenture above referred to, petitioner paid $22,000.00 in discharge of a debt, which represented the amount petitioner had computed as an amount equal to ten percent of net earnings for the calendar year 1936 (as defined by the aforementioned Trust Indenture).

(d) Subsequent to December 16, 1936 petitioner determined that its net earnings for the calendar year 1936 (as defined by the aforementioned Trust Indenture) were $209,493.62 and that ten percent thereof was $20,949.36.

Wherefore, the petitioner prays that this Board may hear the proceedings and find that:

1. A credit in the amount of $20,949.36, representing an amount equal to the portion of the earnings for the calendar year 1936 required to be paid or irrevocably set aside from the petitioner's net earnings for such taxable year for the discharge of a debt, should be allowed against adjusted net income in the computation of the tax on the undistributed adjusted net income of the petitioner.

(Signed) DONALD J. LYNN,
Counsel for Petitioner,
1100 Mahoning National Bank Building, Youngstown, Ohio.
(Signed) H. A. MIHILLS,
Associate Counsel for Petitioner,
917 Munsey Building, Washington, D. C.

5 *Duly sworn to by V. G. Lumbard; jurat omitted in printing.*

Exhibit A to petition

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
Cleveland, Ohio, September 12, 1938.

Office of Commissioner of Internal Revenue, Internal Revenue Agent in Charge, 415 Hanna Building.

Cleveland.
IRA: 90D.

THE OHIO LEATHER COMPANY,
1052 North State Street, Girard Ohio.

GENTLEMEN: You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1936 discloses a deficiency of $3,858.92, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

6 Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 415 Hanna Building, Cleveland, Ohio. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By (Signed) R. C. CAKE,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.
VOD: tm.

STATEMENT

Cleveland.
IRA:90D.

In re: The Ohio Leather Company, 1052 North State Street, Girard, Ohio

TAX LIABILITY FOR THE TAXABLE YEAR ENDED DECEMBER 31, 1936

INCOME TAX

Liability, 1936, $45,683.08; assessed $41,824.16; deficiency $3,858.92.

7 In making this determination of your income tax liability, careful consideration has been given to the report of examination dated April 6, 1938; and to your protest dated June 23, 1938.

In your letter of protest dated June 23, 1938, you stated that a conference was not desired, therefore the statutory notice of deficiency is being issued at this time.

In filing your return for 1936 a credit of $22,000.00 was claimed in determining undistributed net income in the computation of surtax on undistributed profits. The credit was claimed under section 26(c)2 of the Revenue Act of 1936, and was based on a contract dated January 1, 1936.

It appears that under the terms of a bond indenture dated January 1, 1936, you are required to create a sinking fund and deposit therein annually on or before January 1st the sum of $25,000.00, and in addition thereto on or before the next succeeding first day of April an amount equal to 10% of the net earnings of your company for the prior year ended December 31st.

On December 16, 1936, you deposited with the Trustee, The Union National Bank of Youngstown, Ohio, $25,000.00 to cover the sinking fund requirement, and in addition thereto $22,000.00 estimated to represented 10% of your net earnings for the year ended December 31, 1936. The latter amount was claimed as a credit.

Since the payments under the provisions of the bond indenture are not required to be made out of the earnings and profits of the taxable year, it is held that the provisions of the contract in this connection do not satisfy the conditions prescribed in section 26(c)2 of the Revenue Act of 1936. The credit of $22,000.00 as claimed has therefore been disallowed.

TAXABLE YEAR ENDED DECEMBER 31, 1936

Net income as disclosed by return, $248,395.41.

8 COMPUTATION OF TAX

Taxable Year Ended December 31, 1936

INCOME TAX

Normal tax: Taxable net income		$248,395.41
Less:		
Interest on U. S. obligations	$595.84	
Dividends received credit	14,897.25	15,493.09
Net income for normal tax computation		$233,192.32
8% of $2,000.00		$160.00
11% of $13,000.00		1,430.00
13% of $25,000.00		3,250.00
15% of $193,192.32		28,978.85
Total normal tax		$33,818.85

Before United States Board of Tax Appeals

Answer

Filed February 1, 1939

COMES Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and in answer to the petition in the above-entitled proceeding, admits and denies as follows:

1, 2, 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4 (a). Denies that the Commissioner erred as alleged in subparagraph (a) of paragraph 4 of the petition.

5 (a). Admits the allegation of fact contained in subparagraph (a) of paragraph 5 of the petition.

5 (b) and (c). Denies the allegations of fact contained in subparagraphs (b) and (c) of paragraph 5 of the petition.

9 5 (d). Admits the allegation of fact contained in subparagraph (d) of paragraph 5 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the appeal be denied.

Signed) J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
DEWITT M. EVANS,
Division Counsel.
THOS. F. CALLAHAN,
Special Attorney, Bureau of Internal Revenue.

Before United States Board of Tax Appeals

THE OHIO LEATHER COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 96420

D. J. Lynn, Esq., and H. A. Mihills, C. P. A., for the petitioner.
DeWitt M. Evans, Esq., and Thomas F. Callahan, Esq., for the respondent.

Memorandum opinion

Entered June 13, 1940

OPPER: This proceeding was brought for a redetermination of a deficiency in petitioner's income tax in the sum of $3,858.92 for the year 1936.

10 The sole issue involved is whether petitioner is entitled to a credit under section 26 (c) (2) of the Revenue Act of 1936.

Substantially all of the facts are stipulated and are hereby found accordingly. Facts appearing in the summary below which are not part of the stipulation are otherwise found from the record.

Petitioner is an Ohio corporation with its principal office and place of business in Girard, Ohio. On or about April 17, 1936, petitioner entered into a trust indenture bearing date of January 1, 1936, and under which the Union National Bank of Youngstown was trustee.

For the purpose of borrowing money, petitioner directed the issue of its debentures in the aggregate principal amount of $900,000, designated as Ten Year 5% Convertible Sinking Fund Debentures.

The sinking fund provision in the indenture appears in Article Two thereof and in part is as follows:

"SECTION 1. The Company covenants that, to create a Sinking Fund for the further security of the Debentures issued hereunder, it will pay to the Trustee in coin or currency which at the time of payment is legal tender in the United States of America for the payment of private debts, annually on or before January 1, 1937 and each January 1 thereafter to and incuding January 1, 1945, the sum of Twenty-five Thousand Dollars ($25,000), and, in addition, shall, on or before the next succeeding first day of April, pay an amount equal to ten per cent (10%) of the net earnings earned by the Company during the fiscal year end-

ing on the thirty-first day of the next preceding December, as such net earnings are defined hereinafter in this Article, which sums and amounts shall be held by the Trustee for the security of all outstanding Debentures until paid out as hereinafter provided. * * *

"SECTION 2. On or before April 1, 1937, and thereafter annually on or before April 1st in each year to and including
11 April 1, 1945, the Company will cause Ernst & Ernst of Cleveland, Ohio, or such other certified public accountant or accountants as may be approved by the Trustee hereunder, to determine the amount, if any, of the net earnings of the Company for the fiscal year ended the last preceding December 31st.

* * * * *

"SECTION 5. * * *

"In lieu of payment of cash into the Sinking Fund as above provided in Section 1 of this Article, the Company may deliver to the Trustee, to apply upon such payments, Debentures issued hereunder with all unmatured coupons attached thereto, which have previously thereto been issued, sold and repurchased by the Company or otherwise acquired by the Company, and in each such event shall have credit therefor to the extent of the principal amount of such Debentures (but without accrued interest or premium thereupon) so delivered to the Trustee. The fact of re-purchase or re-acquisition by the Company shall be disclosed to the Trustee by a certificate with respect thereto delivered by the Company to the Trustee at the time of the delivery of said Debentures. The Company may, but need not, anticipate payments to the Sinking Fund either in cash or in Debentures and have credit therefor on its thereafter accruing obligation or obligations to pay moneys or deposit Debentures for the Sinking Fund."

* * * * *

As of January 1, 1936, petitioner issued the $900,000 principal amount of 5 per cent Convertible Sinking Fund Debentures which would mature on January 1, 1946. During the year 1936 $81,000 of these bonds were purchased by petitioner at a cost of not less than the principal amount thereof, and on December 16, 1936, bonds with a face value of $47,000 were deposited with the sinking fund trustee, $25,000 of which were required under the bond indenture to be paid on or before January 1, 1937, and
the balance of $22,000, represented approximately 10 per
12 cent of the net earnings of petitioner for the calendar year 1936, which 10 per cent was due and payable "* * * on or before the next succeeding first day of April * * *."

An extract from the minutes of the meeting of petitioner's board of Directors held December 14, 1936, is as follows:

"On motion made by MR. BOOTH, seconded by MR. GAYTON, and unanimously carried, the foregoing resolutions were adopted.

"Whereas, the Indenture covering the Company's issue of Nine Hundred Thousand Dollars ($900,000) Ten Year 5% Convertible Sinking Fund Debentures, due January 1, 1946, dated January 1, 1936, makes mandatory the disposition of net earnings; and

"Whereas, Section 26 (c) 2 of the Revenue Act of 1936 (defining credits permitted in connection with contracts restricting payments of dividends) required the payment or irrevocable setting aside within the taxable year, of the specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936; and

"Whereas, information has been furnished to this Board of Directors that the ten per cent (10%) of the net earnings for the calendar year 1936 is Twenty-Two Thousand Dollars ($22,000).

"Now, therefore, be it resolved, that the officers of this Company be and are hereby authorized and instructed to specifically meet the requirements of said Indenture and Section 26 (c) 2 of the Revenue Act of 1936, and to irrevocably surrender to the Trustee, Debentures covered by said Indenture, with all unmatured coupons attached hereto, together with a certificate signed by the President or the Vice President, or the Treasurer of the Company, as to the price which the Company paid for such Debentures, and that such amount of Debentures to be irrevocably surrendered before December 31, 1936 shall have cost the Company not less than Twenty-Two Thousand Dollars ($22,000)."

13 The $47,000 principal amount of bonds deposited with the trustee on December 16, 1936 were cancelled and cremated.

Subsequent to December 16, 1936, petitioner determined that its net earnings, as defined by the trust indenture for the calendar year ending December 31, 1936, were $209,493.62.

Petitioner filed its income tax return on an accrual basis.

The question presented is identical with that considered in Strong Manufacturing Co., 41 B. T. A. — (May 29, 1940). Respondent's determination disallowing the claimed credit must accordingly be overruled. However, the amount of credit to which petitioner is apparently entitled is $20,949.36 as opposed to the $22,000 originally claimed. This was conceded by petitioner at the hearing by the statement of its counsel that "the

only credit which the company is now claiming is a credit of $20,949.86 instead of the 22 which was actually paid in on December 16". For this reason,

Decision will be entered under Rule 50.

Before United States Board of Tax Appeals

Decision

Entered July 3, 1940

Pursuant to Memorandum Opinion of the Board entered June 13, 1940, the respondent herein on July 1, 1940 having filed a recomputation of tax to which petitioner acquiesces, now, therefore, it is

ORDERED and DECIDED: That there is a deficiency in this petitioner's income tax for the year 1936 in the amount of $178.61.

[SEAL] (S) CLARENCE V. OPPER, *Member.*

14 In United States Circuit Court of Appeals

Petition for review and assignment of error

Filed September 21, 1940

To the Honorable Judges of the United States Circuit Court of Appeals for the Sixth Circuit:

Now comes the Comissioner of Internal Revenue, by his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and John M. Morawski, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I

JURISDICTION

The petitioner on review is the duly appointed, qualified and acting Commissioner of Internal Revenue, hereinafter referred to as the Commissioner, holding his office by virtue of the laws of the United States.

The respondent on review, The Ohio Leather Company (hereinafter referred to as the taxpayer), is a corporation organized and existing under the laws of the State of Ohio, with its principal office and place of business located at 1052 North State Street, Girard, Ohio. The Ohio Leather Company filed its income and excess-profits tax return for the calendar year 1936 with the Collector of Internal Revenue for the 18th District of Ohio,

at Cleveland, Ohio, and within the judicial circuit of the United States Circuit Court of Appeals for the Sixth Circuit.

The petitioner files this petition pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

II

Prior Proceedings

On September 12, 1938, the Commissioner determined a deficiency in income tax for the calendar year 1936 in the amount of $3,858.92, and sent to the taxpayer by registered mail a notice of said deficiency in accordance with the provisions of existing internal revenue laws. Thereafter, and on December 12, 1938, the taxpayer filed a petition for a redetermination of said deficiency by the United States Board of Tax Appeals.

The case was tried before the Board of Tax Appeals on October 23, 1939, at Cleveland, Ohio.

On June 13, 1940, the Board entered its memorandum opinion, and on July 3, 1940, entered its decision that there is a deficiency in income tax for the year 1936 in the amount of $178.61.

III

Nature of Controversy

The issue decided against the Commissioner relates to the credit claimed by the taxpayer, under section 26 (c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits.

As of January 1, 1936, taxpayer issued $900,000.00 principal amount of 5 percent Convertible Sinking Fund Debentures which would mature on January 1, 1946. During the year 1936, $81,000.00 of these bonds were purchased by taxpayer at a cost of not less than the principal amount thereof, and on December 16, 1936, bonds with a face value of $47,000.00 were deposited with the sinking fund trustee, $25,000.00 of which were required under the bond indenture to be paid on or before January 1, 1937, and the balance of $22,000.00 represented approximately 10 percent of the net earnings of the taxpayer for the calendar year 1936, which 10 percent was due and payable "* * * on or before the next succeeding first day of April * * *." Subsequent to December 16, 1936, the taxpayer determined that its net earnings, as defined by the trust indenture, for the calendar year 1936 were $209,493.62, 10 percent of which is $20,949.36. The trust indenture was executed prior to May 1, 1936.

The Commissioner, in his notice of deficiency, refused to allow any credit claimed for contracts restricting dividend payments. The taxpayer claims a credit of $20,949.36. The Board sustained the taxpayer, and stated that the question presented is
16 identical with that considered in Strong Manufacturing Company, (1940) 41 B. T. A.—No. 174 (now pending on Commissioner's petition for review in the Circuit Court of Appeals for the Sixth Circuit).

IV

Assignments of Error

The Commissioner avers that in the record and proceedings before the United States Board of Tax Appeals and in the opinion and final decision rendered and entered by the United States Board of Tax Appeals, manifest error occurred and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceedings, opinion and final decision so rendered and entered by the United States Board of Tax Appeals:

1. In holding and deciding that there is a deficiency in income tax for the year 1936 in the amount of only $178.61.

2. In failing to sustain the deficiency in income tax determined by the Commissioner for the year 1936 in the amount of $3,858.92.

3. In holding and deciding that taxpayer is entitled to the claimed credit of $20,949.36, under section 26 (c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits.

4. In holding and deciding that the question is controlled by Strong Manufacturing Company, 41 B. T. A. — No. 174.

5. In failing to hold that no part of the earnings of the taxpayer for the taxable year was required by any provision of the contract to be paid or irrevocably set aside within the taxable year, and hence taxpayer is not entitled to any credit under section 26 (c) (2).

6. In that its opinion and decision are not supported by the evidence and are contrary to law.

Wherefore, the Commissioner petitions that the decision
17 of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Sixth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the Clerk of

said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed by said Court.

(Sgd.) SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
(Sgd.) J. P. WENCHEL,
C. A. R.
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
JOHN M. MORAWSKI,
Special Attorney, Bureau of Internal Revenue.
Duly sworn to by John M. Morawski; jurat omitted in printing.

18 In United States Circuit Court of Appeals

Notice of filing petition for review

Filed Sept. 26, 1940

To: DONALD J. LYNN, Esq.,
1100 Mahoning National Bank Bldg.,
Youngstown, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 21st day of September 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 21st day of September 1940.

(Signed) B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 25th day of September 1940.

(Signed) DONALD J. LYNN,
Counsel for Respondent on Review.

19 In United States Circuit Court of Appeals

Notice of filing petition for review

Filed September 27, 1940

To: THE OHIO LEATHER COMPANY,
1052 North State Street, Girard, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 21st day of September, 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 21st day of September 1940.

(Signed) J. P. WENCHEL,
C. A. R.
Chief Counsel, Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 24th day of September 1940.

(Signed) THE OHIO LEATHER COMPANY,
Respondent on Review.
(Signed) V. G. LUMBARD, *President.*

20 In United States Circuit Court of Appeals

Statement of points

Filed November 20, 1940

Comes now the petitioner on review herein and makes this concise Statement of Points on which he intends to rely on the review herein, to wit:

The United States Board of Tax Appeals erred:

1. In holding and deciding that there is a deficiency in income tax for the year 1936 in the amount of only $178.61.

2. In failing to sustain the deficiency in income tax determined by the Commissioner for the year 1936 in the amount of $3,858.92.

3. In holding and deciding that taxpayer is entitled to the claimed credit of $20,949.36, under section 26(c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits.

4. In holding and deciding that the question is controlled by Strong Manufacturing Company, 41 B. T. A. — No. 174.

5. In failing to hold that no part of the earnings of the taxpayer for the taxable year was required by any provision of the contract to be paid or irrevocably set aside within the taxable year, and hence taxpayer is not entitled to any credit under section 26(c)(2).

6. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

(Signed) J. P. WENCHEL,
R. L. W.
Chief Counsel, Bureau of Internal Revenue.

Service of a copy of the above statement of points is hereby acknowledged this 14th day of November 1940.

(Signed) H. A. MIHILLS,
Counsel for Respondent on Review.

21 Before United States Board of Tax Appeals

Designation of portions of record, proceedings, and evidence to be contained in record on review

Filed November 20, 1940

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
   (a) Petition,
   (b) Answer to Petition.
3. Board's memorandum opinion and decision.
4. Petition for review.
5. Notices of filing.

6. Statement of points.
7. This designation.

(Signed) J. P. WENCHEL,
Chief Counsel, Bureau of Internal Revenue.

Service of a copy of the within designation of portions of record, proceedings, and evidence to be contained in record on review is hereby admitted this 19th day of November 1940.

(Signed) H. A. MIHILLS,
Counsel for Respondent on Review.

22 In United States Circuit Court of Appeals For the Sixth Circuit

No. 8842

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER ON REVIEW

v.

THE OHIO LEATHER COMPANY, RESPONDENT ON REVIEW

Order permitting enlargement of the record on review

Filed January 10, 1941

On motion of counsel for the Respondent on Review it is Ordered: That an enlargement of the Record on Review herein be permitted by Respondent on Review in order that the same shall receive and include the following additional evidence: Stipulation of facts entered into and agreed upon between the parties herein that the trial of this cause before the United States Board of Tax Appeals, and the Clerk of the United States Board of Tax Appeals is ordered to prepare, transmit and deliver to the Clerk of this Court copies thereof duly certified as correct.

CHARLES C. SIMONS,
Judge of the United States Circuit Court of Appeals.

23 Before United States Board of Tax Appeals

Stipulation of facts

Filed January 18, 1941

It is hereby stipulated and agreed by and between the parties hereto, by their respective attorneys, that the following facts shall

be taken as true, provided, however, that this stipulation shall be without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true:

(1) Petitioner, The Ohio Leather Company, is a Corporation organized and existing under the laws of the State of Ohio with its principal office and place of business located at 1052 North State Street, Girard, Ohio. A Corporation Income and Excess-Profits Tax Return for the calendar year 1936 was filed with the Collector of Internal Revenue for the 18th District of Ohio on or before May 15, 1937.

(2) The amount of alleged deficiency covering income and undistributed profits tax for the calendar year 1936 is $3,858.92.

(3) Prior to May 1, 1936, to-wit, on or about the 17th day of April, 1936, petitioner entered into a Trust Indenture with The Union National Bank of Youngstown, as Trustee, a copy of which is attached hereto, marked "Exhibit A" and made a part hereof.

(4) As of January 1, 1936, the petitioner corporation issued $900,000.00 principal amount of 5% convertible sinking fund debentures which would mature on January 1, 1946. These bonds were sold at a discount to net the issuing corporation $873,000.00. During the year 1936 $81,000.00 of these bonds were purchased by the petitioner at a cost of not less than the principal amount thereof and on December 16, 1936, bonds with a face value of $47,000.00 were deposited with the sinking fund trustee, The Union National Bank of Youngstown, Ohio, $25,000.00 of which were required under the bond indenture to be paid on or before January 1, 1937, and the balance, $22,000.00, represented approximately 10% of the net earnings of the petitioner
24 corporation for the calendar year 1936, which 10% was due and payable, "* * * on or before the next succeeding first day of April * * *."

(5) An extract from the minutes of the meeting of the Board of Directors of the petitioner corporation held on December 14, 1936, is as follows:

"On motion made by Mr. Booth, seconded by Mr. Gayton, and unanimously carried, the foregoing resolutions were adopted.

"Whereas, the Indenture covering the Company's issue of Nine Hundred Thousand Dollars ($900,000) Ten Year 5% Convertible Sinking Fund Debentures, due January 1, 1946, dated January 1, 1936, makes mandatory the disposition of net earnings; and

"Whereas, Section 26 (c) 2 of the Revenue Act of 1936 (defining credits permitted in connection with contracts restricting payments of dividends) required the payment or irrevocable setting

aside within the taxable year, of the specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936; and

"Whereas, information has been furnished to this Board of Directors that the ten per cent (10%) of the net earnings for the calendar year 1936 is Twenty-two Thousand Dollars ($22,000),

"Now, therefore, be it resolved, that the officers of this Company be and are hereby authorized and instructed to specifically meet the requirements of said Indenture and Section 26 (c) 2 of the Revenue Act of 1936, and to irrevocably surrender to the Trustees, Debentures covered by said Indenture, with all unmatured coupons attached hereto, together with a certificate signed by the President or the Vice President, or the Treasurer of the Company, as to the price which the Company paid for such Debentures, and that such amount of Debentures to be irrevocably surrendered before December 31, 1936, shall have cost the Company not less than Twenty-two Thousand Dollars ($22,000)."

25 (6) Subsequent to December 16, 1936, petitioner determined that its net earnings, as defined by the aforesaid Trust Indenture, for the calendar year ending December 31, 1936, were $209,493.62.

(7) That the sole issue in controversy in this proceeding is that of a credit under Section 26 (c) 2 of the Revenue Act of 1936, and, if the Board shall find—

(a) That such credit is not allowable to petitioner then it shall find a deficiency against petitioner in the amount of $3,858.92, but,

(b) If such credit is allowable to petitioner, then it shall find a deficiency against petitioner in the amount of $178.61.

(Signed) H. A. Mihills,
(Signed) Donald J. Lynn,
Counsel for Petitioner,
(Signed) J. P. Wenchel,
D. M. C.
Counsel for Respondent.

Now, January 15, 1941, the foregoing is certified from the record, exclusive of Ex. "A," as a true copy.

[SEAL] (Signed) B. D. Gamble,
Clerk, U. S. Board of Tax Appeals.

26 [Clerk's certificate to foregoing transcript omitted in printing.]

Before United States Board of Tax Appeals

Order enlarging time

On motion of counsel for the petitioner, it is

Ordered: That the time for preparation of the evidence and transmission and delivery of the record sur petition for review of the above entitled proceeding in the United States Circuit Court of Appeals for the Sixth Circuit, be and it is hereby extended to December 20, 1940.

[SEAL] (Signed) C. R. ARUNDELL, *Member.*

Dated, Washington, D. C., October 14, 1940.

Now, December 9, 1940, the foregoing is certified from the record as a true copy.

(Signed) B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

27 In United States Circuit Court of Appeals for the Sixth Circuit

Cause argued and submitted

November 11, 1941

Before HAMILTON, MARTIN, and MCALLISTER, JJ.

This cause is argued by Bernard Chertcoff for Petitioner and by Donald J. Lynn for Respondent and is submitted to the court.

In United States Circuit Court of Appeals

Decree

Entered December 9, 1941

This cause was heard upon the transcript of the record, briefs and arguments of counsel, and on consideration whereof,

It is ordered, adjudged, and decreed that the order of the Board of Tax Appeals be and the same is affirmed in accordance with our opinion in Commissioner of Internal Revenue vs. Strong Manufacturing Company, — Fed. (2d) —, this day decided.

28 [Clerk's certificate to foregoing transcript omitted in printing].

29 Supreme Court of the United States

Order allowing certiorari

Filed April 6, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

[Endorsement on cover:] File No. 46344. U. S. Circuit Court of Appeals, Sixth Circuit. Term No. 40. Guy T. Helvering, Commissioner of Internal Revenue, Petitioner vs. The Ohio Leather Company. Petition for a writ of certiorari and exhibit thereto. Filed March 5, 1942. Term No. 40 O. T. 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942

CLERK'S COPY.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 41

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

THE STRONG MANUFACTURING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 5, 1942
CERTIORARI GRANTED APRIL 6, 1942

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 41

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

THE STRONG MANUFACTURING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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1 Before United States Board of Tax Appeals

Docket No. 95626

THE STRONG MANUFACTURING CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances: For Taxpayer: Sidney J. Collins, Arthur Morgan, Esq., Raymond S. Powers, Esq. For Commissioner: Stanley B. Pierson, De Witt M. Evans, Esq., Paul A. Sebastian, F. N. Morawaski, Esq.

Docket entries

1938

Sept. 26—Petition received and filed. Taxpayer notified. (Fee paid).

Sept. 26—Copy of petition served on General Counsel.

Nov. 8—Answer filed by General Counsel.

Nov. 8—Request for circuit hearing in Cleveland, Ohio, filed by General Counsel.

Nov. 15—Notice issued placing proceeding on Cleveland, Ohio, Calendar. Answer and request served.

1939

Aug. 31—Hearing set Oct. 23, 1939, Cleveland, Ohio.

Oct. 9—Notice of appearance of Arthur Morgan as counsel for taxpayer filed.

Oct. 9—Notice of appearance of Raymond S. Powers as counsel for taxpayer filed.

Oct. 23—Hearing had before Mr. Opper on merits. Briefs due 12/7/39. Reply Briefs due 12/22/39.

Nov. 4—Transcript of hearing of 10/23/39 filed.

Dec. 7—Brief filed by taxpayer, 12/8/39 copy served on General Counsel.

Dec. 7—Brief filed by General Counsel.

Dec. 20—Reply brief filed by taxpayer.

1940

Feb. 5—Motion for leave to file the attached supplemental memorandum. Memorandum lodged filed by taxpayer. 2/6/40 granted.

May 29—Findings of fact and opinion rendered. Clarence V. Opper, Div. 14. Decision will be entered under Rule 50.

June 21—Computation of deficiency filed by General Counsel.

June 21—Consent to settlement filed by taxpayer.

June 26—Decision entered, C. R. Arundell, Div. 7.

Sept. 14—Petition for review by United States Circuit Court of Appeals, Sixth Circuit, with assignments of error filed by General Counsel.
Sept. 19—Proof of service filed by General Counsel (1).
Sept. 23—Proof of service filed by General Counsel (1).
Oct. 8—Designation of additional portions of record filed by taxpayer, with proof of service thereon.
Oct. 9—Motion for extension of time to Dec. 13, 1940 to complete and transmit the record filed by General Counsel.
Oct. 9—Order enlarging time to Dec. 13, 1940 to prepare and transmit the record, entered.
Oct. 24—Statement of points with proof of service thereon filed by General Counsel.
Oct. 24—Agreed praecipe filed.
Oct. 24—Notice that proceeding has been placed upon the Day Calendar of 11/6/40 for settlement *re* contents of record *sur* petition for review.

3 Nov. 6—Hearing had before Mr. Opper on settlement of contents of record. Ordered that such part of transcript and exhibits as petitioner feels necessary should be included in record on appeal.
Nov. 8—Motion that a transcript of all oral testimony and documentary exhibits offered in evidense herein be included in the record on review of this cause as requested by said respondent in its designation of additional portions of record proceedings and exhibits to be contained in record on review filed Oct. 8, 1940 filed by taxpayer. Granted.
Nov. 19—Transcript of hearing 11/6/40 filed.

Before United States Board of Tax Appeals

Petition

Filed September 26, 1938

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols CLEVELAND IRA-90D-VOD: tm) dated June 30, 1938, and as a basis of its proceedings alleges as follows:

1. The petitioner is an Ohio corporation with its principal office in the Village of Sebring, Ohio.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on June 30, 1938.

3. The deficiency asserted is for the calendar year 1936, as follows:

Income tax	$14,776.89
Excess-profits tax	548.37
Total	$15,325.26

Of this amount, $12,732.10 of income tax and $96.04 of excess-profits tax are in controversy.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) In determining the net income of the petitioner for the year 1936 the Commissioner erroneously disallowed as a deduction $2,215.88 of items charged by petitioner to repair account, less $156.39 of additional depreciation applicable thereto, or a net deduction of $2,059.49 erroneously disallowed.

(b) In determining the amount of undistributed net income of the petitioner subject to surtax the Commissioner erred in disallowing as a credit against such undistributed net income the amount which the petitioner pursuant to the terms of a written contract entered into prior to May 1, 1936, was required to pay or set aside out of the earnings and profits of the taxable year for the payment of mortgage indebtedness.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner charged to repair account during the year 1936, $10,383.63 of items which the Examining Officer classified as plant betterments and disallowed as a deduction; many of these items were on the border-line between repairs and improvements, and at a hearing subsequently held at the office of the Internal Revenue Agent in Charge it was agreed between representatives of the Commissioner and of the petitioner that $2,215.88 would be allowed as a deduction, and overallowance of depreciation corrected accordingly.

(b) The agreement referred to in (a) was confirmed by letter of John R. Kirk, Internal Revenue Agent in Charge, under date of February 25, 1938, attached to which were schedules showing the adjustments as agreed, and recomputation of excess-profits and income taxes in accordance therewith.

(c) On April 21, 1932, the petitioner executed a purchase-money mortgage, together with a series of notes secured thereby, to Central United National Bank, Trustee, Cleveland, Ohio; copy of the relevant covenants contained in said notes and mortgage is attached hereto and marked Exhibit B.

(d) Pursuant to its understanding of the terms of the aforesaid notes and mortgage, the petitioner made an approximate

determination of its profits from time to time during 1936, and made principal payments to Central United National Bank, Trustee, during the taxable year, to the amount of $47,000.00, which extinguished the debt.

(e) The total of principal and interest payments to the mortgagee during the year 1936 was less than the forty per centum (40%) of net earnings required to be applied to such payments and therefore the entire sum of $47,000.00 paid on the principal of the debt was claimed as a credit against undistributed net income, in petitioner's income tax return for 1936.

Wherefore, the petitioner prays that this Board may hear the proceeding and determine that the deficiency due from the petitioner for the year 1936 should not be in excess of $2,497.12.

(Signed) SIDNEY J. COLLINS, C. P. A.,
Counsel for Petitioner,
Mahoning Bank Bldg., Youngstown, Ohio.

[*Duly sworn to by W. U. Pfaeffli; jurat omitted in printing.*]

6 EXHIBIT A TO PETITION

[Copy]

CLEVELAND
IRA:90D

JUNE 30, 1938.

STRONG MANUFACTURING COMPANY,
Sebring, Ohio.

GENTLEMEN: You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936 discloses a deficiency of $14.776.89 and that the determination of your excess-profits tax liability for the year mentioned discloses a deficiency of $548.37 as shown in the statement attached.

In accordance with Section 272 (a) of the Revenue Act of 1936, notice is hereby given of the deficiencies mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies above stated.

Should you not desire to file a petition, you are requested
7 to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 415 Hanna Building, Cleveland, Ohio. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the de-

ficiency and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By (Signed) R. C. CAKE,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form 870.

STATEMENT

In re: Strong Manufacturing Company, Sebring, Ohio

STATEMENT OF TOTAL TAX LIABILITY

INCOME TAX LIABILITY

Year ended	Liability	Assessed	Deficiency
Dec. 31, 1936	$39,752.69	$24,975.80	$14,776.89

Excess-profits Tax Liability

Dec. 31, 1936	$2,155.53	$1,607.16	$548.37

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the internal revenue agent's report dated June 9, 1937, a copy of which was mailed to you under date of November 18, 1937; to your protest dated December 16, 1937; and to the statements made at the conferences held on December 29, 1937, February 10, 1938, March 31, 1938 and June 10, 1938.

8 In filing your return for 1936, a credit was claimed in the amount of $47,000.00 in determining undistributed net income, in the computation of surtax on undistributed profits. The credit claimed was based on a contract (mortgage deed and mortgage note) dated April 15, 1932, which you allege restricted the payment of dividends.

It appears that the payments required under the provisions of the mortgage deed and mortgage note are specifically enumerated in the note, and are not, according to the express provisions of the said mortgage deed and mortgage note, required to be made out of the earnings and profits of the taxable year. Accordingly, it is held that the provisions of the contract in this connection do not satisfy the conditions prescribed in Section 26 (c) (2) of the Revenue Act of 1936.

The further requirements of the mortgage deed and mortgage note with respect to the application of 40 per centum of your net earnings for any calendar year, in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th, in such year, which payment was to be made not later than April 15th, of the succeeding year, likewise, do not meet the requirements of Section 26 (c) (2) of the Act for the reason that such contractual provision, although it expressly deals with the earnings and profits of the taxable year, does not require the payment or irrevocable setting aside within the taxable year of such earnings and profits, as specifically provided by the Revenue Act of 1936.

The credit of $47,000.00, has therefore been disallowed.

A copy of the statutory notice of the deficiency, together with a copy of this statement, has been mailed to your representative, Mr. Sidney J. Collins, 711 Mahoning Bank Building, Youngstown, Ohio, in accordance with the authority contained in a power of attorney executed by you and on file in this office.

9 ADJUSTMENTS TO NET INCOME

Year ended Dec. 31, 1936

Net income as disclosed by return		$126,788.04
Unallowable deductions:		
(a) Plant betterments expenses	$10,383.63	
(b) Accrued county taxes	229.86	
		10,613.49
Total		$137,399.53
Additional deductions:		
(c) Depreciation increased	$1,351.08	
(d) Capital stock tax	123.00	
		1,474.08
Net income adjusted		$135,925.45

EXPLANATION OF ADJUSTMENTS

(a) The amount of $10,383.63, expended in the rebuilding and modernizing of your plant and equipment, constitutes a capital expenditure, and is not deductible from gross income. A schedule of the items and amounts involved in the total of $10,383.63 is attached to the revenue agent's report as Exhibit D, a copy of which was furnished you.

(b) Taxes of $5,318.25 claimed as a deduction have been decreased by $229.86, which amount represents the excessive accrual of real estate taxes.

(c) Depreciation of $5,288.31, as claimed has been increased to $6,639.39, resulting in an additional deduction of $1,351.08 as

explained in Exhibit C of the revenue agent's report, a copy of which was furnished you.

(d) Capital stock tax of $1,123.00, for the year ended June 30, 1937, which accrued on July 1, 1936, has been allowed as a deduction in lieu of $1,000.00, as claimed, resulting in a further deduction of $123.00.

10

COMPUTATION OF TAX

Year ended Dec. 31, 1936

EXCESS-PROFITS TAX

Net income for excess-profits tax computation		$135,925.45
Less:		
Dividends received credit	None	
10% of $1,000,000.00, value of capital stock as declared in your capital stock tax return for the year ended June 30, 1936	$100,000.00	
		100,000.00
Net income subject to excess-profits tax		$35,925.45
Excess-profits tax at 6% on $35,925.45 (net income or 5% of declared value of capital stock, whichever is less)		$2,155.53
Excess-profits tax assessed:		
Original Account No. 400301		1,607.16
Deficiency of excess-profits tax		$548.37

INCOME TAX

Normal Tax

Net income for excess-profits tax computation	$135,925.45
Less: Excess-profits tax as computed above	2,155.53
Net income for income tax computation	$133,769.92
Normal tax at 8% on $2,000.00	$160.00
Normal tax at 11% on $13,000.00	1,430.00
Normal tax at 13% on $25,000.00	3,250.00
Normal tax at 15% on $93,769.92	14,065.49
Total normal tax	$18,905.49

SUBTAX OF UNDISTRIBUTED PROFITS

Net income for surtax computation		$133,769.92
Less: Normal tax as computed above		18,905.49
(a) Adjusted net income		$114,864.43
11 Less:		
Dividend paid credit	$10,000.00	
Credit for contract restricting dividend payments	None	
		10,000.00
(b) Undistributed net income		$104,864.43
Less: Specific credit		None
(c) Remainder subject to surtax		$104,864.43

SURTAX ON UNDISTRIBUTED PROFITS—continued

7% of $11,486.44 (portion of (c) not over 10% of (a))	$804.05
12% of $11,486.44 (over 10% and not over 20% of (a))	1,378.37
17% of $22,972.88 (over 20% and not over 40% of (a))	3,905.39
22% of $22,972.88 (over 40% and not over 60% of (a))	5,054.03
27% of $35,945.79 (on excess over 60% of (a))	9,705.36
Total surtax	$20,847.20
Normal tax	18,905.49
Total normal and surtax	$39,752.69
Normal tax and surtax assessed:	
Original, Account No. 400301	24,975.80
Deficiency of income tax	$14,776.89

Exhibit "B" to petition

EXCERPT FROM MORTGAGE NOTE

"As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price,
12 provided that the amount so applied shall never be less than the installments of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof."

EXCERPT FROM MORTGAGE DEED

ARTICLE I (1) OF COVENANTS

"The Company covenants and agrees that until the principal and interest of the note secured hereby shall have been fully paid and beginning on January 1st, One thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenent herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the install-

ment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note.

"The term 'net earnings' as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company, and fixed charges other than those created by the note hereby secured.

"Settlement for all amounts becoming due and payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

13 Before United States Board of Tax Appeals

Answer

Filed November 8, 1938

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the deficiencies asserted are for the calendar year 1936, and are income tax of $14,776.89 and excess-profits tax of $548.38, total $15,325.26, but denies the remaining allegations contained in paragraph 3 of the petition.

4 (a) and (b). Denies the Commissioner erred in the determination of the deficiencies as alleged in sub-paragraphs (a) and (b) of paragraph 4 of the petition.

5 (a) and (b). Denies the allegations contained in sub-paragraphs (a) and (b) of paragraph 5 of the petition.

5 (c). Admits that on April 21, 1932, the petitioner executed a purchase-money mortgage, together with a series of notes secured thereby, to Central United National Bank, Trustee, Cleveland, Ohio, but denies the remaining allegations contained in sub-paragraph (c) of paragraph 5 of the petition.

5 (d) and (e). Denies the allegations contained in sub-paragraphs (d) and (e) of paragraph 5 of the petition.

6. Denies generally each and every allegation contained in the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's determination of deficiency be approved.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
DEWITT M. EVANS,
PAUL A. SEBASTIAN,
Special Attorneys,
Bureau of Internal Revenue.

14 Before United States Board of Tax Appeals

Findings of Fact and Opinion

Docket No. 95626. Promulgated May 29, 1940. Contract requiring application of a portion of petitioner's earnings and profits for the taxable year against indebtedness incurred prior to 1936, held, to require irrevocable setting aside of such portion and to entitle petitioner to a credit for purposes of the undistributed profits tax to the extent that such payment was actually made in the taxable year. Revenue Act of 1936, sec. 26 (c) (2).

Arthur Morgan, Esq., Raymond S. Powers, Esq., and Sidney J. Collins, C. P. A., for the petitioner.

DeWitt M. Evans, Esq., Paul A. Sebastian, Esq., and Stanley B. Pierson, Esq., for the respondent.

This proceeding was brought for a redetermination of a deficiency in petitioner's income and excess profits taxes in the amounts of $14,776.89 and $548.37, respectively, for the year 1936.

The issues presented by the pleadings are: (1) Whether petitioner is entitled to a credit under the provisions of section 26 (c) (2) of the Revenue Act of 1936 in computing the surtax on its undistributed profits; and (2) whether petitioner was entitled to certain deductions for expenditures for repairs and replacements.

FINDINGS OF FACT

Petitioner, an Ohio corporation organized in 1932, has its principal offices at Sebring, Ohio, and is engaged in the manufacture of enamelware.

On or about April 15, 1932, petitioner purchased its plant and equipment from the Central United National Bank, Cleveland, Ohio, trustee for the bondholders of the Sebring Manufacturing Corporation. The purchase price was $50,000, for which peti-

tioner on April 15, 1932, executed a note secured by a mortgage to the Central United National Bank (hereinafter referred to as the bank).

15 The note was as follows:

"For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941

"Any unpaid portion of the said principal sum shall bear interest from April 15, 1932 at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

"This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

"As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The

16 Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obliga-

tory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof."

On the same date petitioner executed the mortgage securing the note. Its pertinent provisions are as follows:

"ARTICLE I

"Anticipation of Payments upon Note

"(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term "net earnings" as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

17 Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured remain unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment, be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand, at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note.

* * * * * *

18 "ARTICLE IV

"Remedies on Default

"(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1 hereof, and such default shall have continued for thirty (30) days; * * * the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. * * *

"(2) No waiver by the Bank of any such default by the Company, whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom."

* * * * * *

The provision of article I, paragraph 1, above quoted, with reference to petitioner's obligation to apply 40 percent of the earnings of each year on the note and mortgage, was required by the bank in order that in prosperous years petitioner would devote a portion of its profits to the payment of the mortgage, and the bank would be protected to this extent should the company later become involved in difficulties.

On May 28, 1934, petitioner and the bank executed an agreement wherein it was recited that the company was not able to pay the principal installment of $2,000 due April 15, 1934, and was in default in payment of the interest in the approximate amount of $3,500. By the agreement the bank granted an extension to April 15, 1941, for the payment of the principal installment and an extension to April 15, 1935, for $3,000 of the delinquent
19 interest. The extension on the principal payment was "with the understanding, however, that such extension shall not be construed as a waiver of any subsequent defaults."

There was no modification of the provision requiring petitioner to apply 40 percent of its net earnings in payment of the principal and interest.

Petitioner's income and excess profits tax return for the year 1936 reported a net income of $126,786.04.

On January 1, 1936, petitioner owed $47,000 on its indebtedness on the note and mortgage. During the year 1936 it made payments on the principal sum on the dates and in the amounts as follows:

2/15/36	$2,500	6/29/36	$1,000	9/15/36	$5,00
4/15/36	2,500	7/14/36	500	10/15/36	34,000
5/15/36	500	7/31/36	1,000		
5/29/36	1,000	8/14/36	500	Total	46,500
6/15/36	500	8/31/36	2,000		

The bank accepted the $46,500 payment in 1936 in full satisfaction of the $47,000 due, and also forgave $117.50 interest.

By September 30, 1936, petitioner's approximate profits were $86,000, and it had orders on its books in that month of approximately $100,000. Since it appeared that petitioner's profits would be such that 40 percent thereof would be in excess of the amount required to discharge the mortgage in full, it was decided to make the payment at that time. It would not have been possible to determine on January 1, 1937, the profits of petitioner for 1936 with complete accuracy.

The parties have stipulated, and we accordingly find, that petitioner should be allowed deduction of $2,215.88 as expenses for repairs and replacements during the taxable year.

Opinion

OPPER: The present issue calls for the application to the foregoing facts of the provisions of section 26 (c) (2) of Revenue Act of 1936 [1] entitling a corporation to a "credit" against the "undistributed profits tax" if it complies with certain requirements.

[1] SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * *

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

* * * * * * *

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits, as used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the "application" to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract "as of" the taxable year, *Michigan Silica Co.*, 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled.

Repair and replacement expenses may be deducted as stipulated.

Reviewed by the Board. Decision will be entered under Rule 50.

21 BLACK, dissenting: I can readily agree that from the standpoint of reason and logic there would seem just as good reason for Congress to grant a credit in determining surtax on undistributed profits to a corporation situated as was the petitioner in the instant case as there was to other corporations which had contracts of indebtedness which come more precisely within the terms of the statute (sec. 26 (c) (2), 1936 Act). But it is the precise statute which we have to construe and I do not see how it can be so broadly construed as to admit a credit to petitioner under the facts as they have been found.

The statute in question, which has been set out in the majority opinion, seems to provide four things as conditions precedent to securing the credit. These are:

(1) There must exist a written contract executed by the corporation prior to May 1, 1936. Here there was a written contract executed prior to May 1, 1936, and so that condition is fulfilled.

(2) This contract must deal with the earnings and profits of the taxable year. The contract in question does deal with 40 percent of the net earnings of petitioner for the taxable year, so that condition is met.

(3) The contract must require the payment or the irrevocable setting aside of the earnings in question during the taxable year for the discharge of the debt in question. In the instant case

it is plain that the contract does not require that the 40 percent of the net earnings be paid on the indebtedness during the taxable year. On the contrary, petitioner was granted until April 15 of the following year in which to make payment. So it seems clear to me that, in so far as payment is concerned, the contract in question does not meet the terms of the statute. But the statute grants the credit if there is a requirement in the contract that the portion of earnings in question be "irrevocably set aside" during the taxable year for the discharge of the debt. I see nothing in the contract which required the taxpayer to irrevocably set aside any of its earnings of 1936 prior to the granted time of payment which was April 15, 1937. So, in the
22 view I take, one of the conditions precedent is not met.

I can not take the view expressed in the majority opinion that when the statute says that the contract must require either payment or irrevocable setting aside of earnings within the taxable year it means "as of" the taxable year. I see no warrant for such construction.

(4) The credit granted, when all conditions have been fulfilled, is the amount which "has been so paid or set aside." In the instant case there has been a payment all right on the indebtedness to the full extent of the credit claimed, but, as I view it, in the absence of a requirement in the contract that these earnings be paid or irrevocably set aside in 1936, their actual payment in 1936 becomes immaterial.

Congress in the Revenue Act of 1938 wrote a provision which seems to be broad enough to permit a credit under the facts and circumstances of the instant case. See sec. 27 (a) (4), Revenue Act of 1938. This section, however, has no retroactive application and, for reasons which I have already stated, I do not believe that the credit which petitioner claims can be granted under the terms of the 1936 Act. I think the Commissioner should be sustained and I, therefore, respectfully dissent from the majority opinion.

MELLOTT and KERN agree with this dissent.

23 Before United States Board of Tax Appeals

Decision

Entered June 26, 1940

Pursuant to the Findings of Fact and Opinion of the Board promulgated May 29, 1940, the respondent herein on June 21, 1940, having filed a recomputation of tax and the petitioner on

June 21, 1940, having filed an acquiescence therein, now, therefore, it is

Ordered and Decided: That there are deficiencies in this petitioner's income and excess-profits taxes for the year 1936 in the respective amounts of $2,133.63 and $420.40.

(Signed) C. R. ARUNDELL, *Member.*

Enter:

In United States Circuit Court of Appeals

Petition for Review and Assignments of error

Filed September 14, 1940

To the Honorable Judges of the United States Circuit Court of Appeals for the Sixth Circuit:

Now comes the Commissioner of Internal Revenue, by his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and John M. Morawski, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I

JURISDICTION

The petitioner on review is the duly appointed, qualified and acting Commissioner of Internal Revenue, hereinafter referred to as the Commissioner, holding his office by virtue of the laws of the United States.

24 The respondent on review, The Strong Manufacturing Company, (hereinafter referred to as the taxpayer), is a corporation organized and existing under the laws of the State of Ohio, with its principal office in the Village of Sebring, Ohio. The Strong Manufacturing Company filed its income and excess-profits tax return for the calendar year 1936 with the Collector of Internal Revenue for the 18th District of Ohio, at Cleveland, Ohio, and within the judicial circuit of the United States Circuit Court of Appeals for the Sixth Circuit.

II

Prior Proceedings

On June 30, 1938, the Commissioner determined deficiencies in income and excess-profits taxes for the year 1936 in the respective amounts of $14,776.89 and $548.37, and sent to the taxpayer by registered mail a notice of said deficiencies in accordance

with Section 272 (a) of the Revenue Act of 1936. Thereafter, and on September 26, 1938, the taxpayer filed a petition for a redetermination of said deficiencies by the United States Board of Tax Appeals.

The case was tried before the Board of Tax Appeals on October 23, 1939, at Cleveland, Ohio.

On May 29, 1940, the Board promulgated its findings of fact and opinion (41 B. T. A. —, No. 174), and on June 26, 1940 entered its decision that there are deficiencies in income and excess-profits taxes for the year 1936 in the respective amounts of $2,133.63 and $420.40.

III

Nature of Controversy

The issue decided against the Commissioner relates to the credit claimed by the taxpayer, under Section 26 (c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits. On January 1, 1936, taxpayer owed $47,000 on its indebtedness on a note and mortgage. During the year 1936, under Section (1) of Article I of the mortgage, taxpayer made payments on the principal sum in the aggregate amount of $46,500.

Said Section (1) of Article I reads as follows:

"ARTICLE I

"Anticipation of Payments Upon Note

"(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term 'net earnings' as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

"Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely

required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

The Commissioner, in his notice of deficiency, refused to allow any credit claimed for contracts restricting dividend payments, on the ground that the amount in question was not required by the contract to be paid or irrevocably set aside, within the taxable year as provided by Section 26 (c) (2) of the statute. The
26 taxpayer claimed a credit of $16,500. The Board of Tax Appeals, however, sustained the taxpayer.

IV

Assignments of Error

The Commissioner avers that in the record and proceedings before the United States Board of Tax Appeals and in the opinion and final decision rendered and entered by the United States Board of Tax Appeals, manifest error occurred and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceedings, opinion and final decision so rendered and entered by the United States Board of Tax Appeals.

1. The Board erred in holding and deciding that there is a deficiency in income tax for the year 1936 in the amount of only $2,133.63.

2. The Board erred in failing to sustain the deficiency in income tax determined by the Commissioner for the year 1936 in the amount of $14,776.89 less the proper reduction of said amount to reflect the adjustments agreed upon by the parties at the hearing before the Board of Tax Appeals.

3. The Board erred in holding that "we are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, Michigan Silica Co., 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute."

4. The Board erred in holding that the credit should have been allowed and that the Commissioner's determination to the contrary is overruled.

5. The Board erred in that its opinion and decision are not supported by the evidence and are contrary to law.

Wherefore, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States
27 Circuit Court of Appeals for the Sixth Circuit, that a transcript of the record be prepared in accordance with

law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed by said Court.

(Sgd.) SAMUEL O. CLARK, JR.,
Assistant Attorney General,
(Signed) J. P. WENCHEL,
CAR
Chief Counsel;
Bureau of Internal Revenue.

Of Counsel:
JOHN M. MORAWSKI,
Special Attorney,
Bureau of Internal Revenue.

[*Duly sworn to by John M. Morawski; jurat omitted in printing.*]

28 In United States Circuit Court of Appeals

Notice of filing petition for review.

Filed September 19, 1940

To: ARTHUR MORGAN, Esq., and
RAYMOND S. POWERS, Esq.,
704 Union National Bank Building,
Youngstown, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 14th day of September, 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 14th day of September, 1940.

(s) B. D. GAMBLE, *Clerk,*
U. S. Board of Tax Appeals.

Service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 17th day of September 1940.

(s) ARTHUR MORGAN,
(s) RAYMOND S. POWERS,
Attorneys for Respondent on Review.

29 In United States Circuit Court of Appeals

Notice of filing petition for review

Filed September 23, 1940

To: THE STRONG MANUFACTURING COMPANY,
Sebring, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 14th day of September 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 14th day of September 1940.

(Signed) J. P. WENCHEL,
CAR
Chief Counsel,
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 17th day of September 1940.

(s) T. F. SHAFFER, *Secy.-Treas.,*
Respondent on Review.

30 Before United States Board of Tax Appeals

Designation by respondent on review of additional portions of record, proceedings, and evidence to be contained in record on review

Filed October 8, 1940

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following additional documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit, heretofore filed by the Commissioner of Internal Revenue:

(1) Transcript of all oral testimony and documentary exhibits offered in evidence herein.

(s) ARTHUR MORGAN,
(s) RAYMOND S. POWERS,
Counsel for Respondent on Review.

Service of a copy of the within designation of additional portions of record, proceedings, and evidence to be contained in the record on review is hereby admitted this 4th day of October 1940.

(s) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

31 Before United States Board of Tax Appeals

Statement of evidence

Filed November 4, 1939

Hearing at Cleveland, Ohio, on the 23rd day of October, 1939, at 2:30 o'clock P. M.

The above entitled proceeding came on for hearing on this the 23rd day of October, 1939, before the Honorable CLARENCE V. OPPER, Member of the United States Board of Tax Appeals, at Cleveland, Ohio, pursuant to notice of hearing heretofore given; whereupon, the following proceedings were had and testimony heard, to-wit:

Appearances: Raymond S. Powers, Esq., Union National Bank Building, Youngstown, Ohio, appearing on behalf of the Petitioner. Stanley B. Pierson, Esq., (Honorable J. P. Wenchel, Chief Counsel) appearing on behalf of Bureau of Internal Revenue, Commissioner of Internal Revenue, Respondent.

32 SIDNEY J. COLLINS, called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

The CLERK. State your name, please.

The WITNESS. Sidney J. Collins.

Direct examination by Mr. POWERS:

Q. You are a certified public accountant, are you?

A. Yes.

Q. You are member of what firm of accountants?

A. Clark & Collins, Certified Public Accountants.

Q. Where do you live, Mr. Collins?

A. Youngstown, Ohio.

Q. Does your firm have offices otherwise than in Youngstown?
A. Yes.
Q. What cities?
A. Cleveland, Canton, Warren, and Youngstown.
Q. You are the State Board of Accountancy, are you?
A. Ohio State Board.
Q. For how long have you been a member of that board?
A. Ten years.
Q. Mr. Collins, you have been doing accounting work for the Strong Manufacturing Company?
A. Yes.
Q. Will you state what the profits of the Strong Manufacturing Company were in the year 1936?
53 A. With reference to the income tax return prepared by our office, the profits were $126,786.04.
Q. And that is modified, of course, by the stipulation in this case in regard to——
A. Under the stipulation agreed to by Petitioner and Respondent, the amount of $8,000.00, the exact amount I do not have, would be reflected in the profits by increasing them for that year in that amount.
Q. You prepared that income tax report, Mr. Collins, did you?
A. It was prepared under my supervision.
Q. Calling your attention to Exhibits 2 and 3 of Petitioner, are you familiar with their contents?
A. I am.
Q. And when it came to the end of the year, 1936, what did you do in relation to these contracts as effecting the setting aside of funds for any particular purpose? What did you consider your duties and obligations were as accountant of the Strong Manufacturing Company?
Mr. PIERSON. Just a moment, Your Honor. I object to that. I believe that this witness can probably state what he did, but as to his duties and obligations, I object to that part of the question.
Mr. POWERS. I withdraw the question and will reframe it, with your permission.

By Mr. POWERS:

Q. What did you do, Mr. Collins, at any time during the year 1936 in regard to this contract and to the accounts of the Strong Manufacturing Company?
A. As a certified public accountant, it becomes part of our duties to be familiar with income tax laws, so that we might prepare these tax returns in accordance with those laws and

regulations. The undistributed income tax feature, of course, was studied a great deal, and in this case the instruments requiring the payment of forty per cent of net earnings was considered as a deduction, as a contract under Section 26C–2 so that this amount, $47,000.00, was so deducted in the preparation
54 of the Strong Manufacturing Company's tax return for the year 1936.

Q. Was there any conference prior to the payment of these sums or any part of these sums by the Strong Manufacturing Company to the Central United National Bank on which your advice was asked?

A. Yes. In September of 1936 the President and Treasurer of the company and their counsel, Mr. Morgan, invited us to a conference on the question of the payment of the mortgage and its requirement under this contract. There were several discussions with other attorneys on the point, and the Treasurer showed the profits to September 30th, which we checked on the books, and they also—that is, the Treasurer submitted evidence of future earnings for the balance of that year. Insofar as it is possible, we determined this, reported to the company officials our estimate that profits would be in excess of forty per cent. That, of course, would be subject to something that might happen during the year after September 30th. However, it was our recommendation that since the profits were to be such that forty per cent, being in excess of the requirements of this contract, if they were able financially to do so, that they would pay during the year on the contract. Does that answer your question?

Q. Would it have been possible to determine the exact earnings of the Strong Manufacturing Company as of December 31, 1936, for the preceding taxable year on January 1st? I mean, would it have been physically possible?

A. No. The whole structure of accounting is based at the close of the year, December 31st, at midnight. The books must yet be closed, inventories must be checked. Proper recognition of that is given by the income tax requirement that tax return be filed two and a half months following the close of the year. So it is actually impossible to determine the exact profits in the calendar year as of December 31st in that year.

Q. And this applies to the Strong Manufacturing Company?

55 A. Yes. And in the study of the law under 26C–2 we had to——

Mr. PIERSON. Now, if your Honor please——

A. We had—I am going to state what we told the company.

Mr. PIERSON. All right.

A. We instructed or notified this company that the construction of that law was our opinion—rather, our opinion was that the construction of 26C–2 was that they must pay or irrevocably set aside forty percent of the profits in the year 1936. We did explain to them, upon their request, as to this payment, it would be physically impossible for them to be sure of profits until after the books were closed. We, therefore, put our own construction on this contract that the law, including irrevocably setting aside, was taking care of that contingency where the company was not sure as of December 31st that the profits would be sufficient to require the payment of forty percent.

Q. In your experience, are there any companies who could have determined their profits within the taxable year, accurately?

Mr. PIERSON. Just a moment. I object to that, Your Honor. I think it is immaterial, irrelevant.

Mr. POWERS. As I understand it, that is the issue in this case. It is because the provision of the contract permitted the payment of the money, the actual physical transfer of the money on or before April 15th of the succeeding year; that it is contended by counsel for the Commissioner of the Internal Revenue Department that because the money is not paid over or required to be paid over before the end of the taxable year, that, therefore, the contract does not come within the 26C–2, and it is our purpose to demonstrate that this is an utterly impractical construction of 26C–2, and makes it utterly impossible of performance.

The MEMBER. I will overrule the objection and allow this witness to answer for what it is worth. The experience of one accountant as to the offices he has had contact with, raises a serious doubt in my mind whether it is worth anything, but I will overrule the objection.

56.

By Mr. POWERS:

Q. First, Mr. Collins, I will ask you how long have you been in the accounting business?

A. Since I came back from France; 1919.

Q. Over that period of time, what has been your experience?

A. I have served as an instructor in accountancy in the university, been actively engaged in accounting since 1921 in public practice. During that time I have appeared before the Board of Tax Appeals on income tax many times.

Q. How many companies have you prepared income tax returns for?

A. It would be rather difficult, Mr. Powers, but we have some two hundred active clients at the present time.

Q. Are they conducting one type of business, or are they diversified?

A. All kinds.

Q. Would you consider they represent a cross section of industrial activity in this vicinity?

A. I do.

Q. I will ask you, Mr. Collins, if any of those corporations could accurately determine their profits on December 31st of the year in which those profits are earned?

A. It would be physically impossible to determine the actual profits of the calendar year as of the last day.

Q. Of any of the corporations you represent?

A. Any corporations, with one exception of the bank, which, as of the close of the next day, there is a trial balance which does show the profits as of that year.

Q. How about industrial corporations?

A. Industrial corporat. ns, no. I might add, any corporation that has a physical inventory on which it bases
57 its profits, could not take that inventory until the close of the year. If they did, they would be subject to penalty from the income tax department for not having the correct inventories.

Q. And therefore, if a contract or a mortgage obligation provided for the application of a certain percentage of profits payable in the year in which the profits were earned, it would be impossible for a corporation to comply with those conditions?

Mr. PIERSON. I object to that, Your Honor.

A. Absolutely.

Mr. PIERSON. Just a moment. I object to that, Your Honor.

The MEMBER. I will take it for what it is worth. Overrule the objection.

Mr. PIERSON. No questions.

Witness excused.

85 *Petitioner's Exhibit 2*

October 15, 1936. Paid.

CENTRAL NATIONAL BANK OF CLEVELAND,

(Signed) ANTHONY POSS,

Authorized Officer.

(S. B. Pierson)

CLEVELAND, OHIO, *April 15, 1932.*

For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all

payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941

Any unpaid portion of the said principal sum shall bear interest from April 15, 1932, at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

86 As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof.

THE STRONG MANUFACTURING COMPANY,
(Signed) By W. U. PFAEFFLI,
President.

Attest:

(Signed) T. F. SHAFFER,
Secretary.

Petitioner's Exhibit 3

(S. B. Pierson)

OCTOBER 15, 1936.

The conditions of the within mortgage have been complied with and the same is hereby satisfied and discharged.

CENTRAL NATIONAL BANK OF CLEVELAND
(Successor by change of name to Central United B).

This Indenture of Mortgage, made as of the 15th day of April, One Thousand nine hundred and thirty-two, by and between The Strong Manufacturing Company (hereinafter sometimes called the "Company"), a corporation organized and existing
87 under and by virtue of the laws of the State of Ohio and having a legal residence and principal office and place of business in the Village of Sebring, County of Mahoning and State of Ohio, party of the first part, and Central United National Bank of Cleveland (hereinafter sometimes called the "Bank"), a corporation organized and existing under and by virtue of the laws of the United States of America, and having a legal residence and principal office and place of business in the City of Cleveland, County of Cuyahoga and State of Ohio, party of the second part.

Whereas, the Bank has heretofore acquired title to the property hereinafter more particularly described in trust for the holders of certain bonds outstanding as of December 22, 1931, which bonds were issued under a certain Indenture of First Mortgage dated September 15, One thousand nine hundred and twenty-five and executed by Sebring Manufacturing Corporation; and

Whereas, the Bank has by action of more than a majority of said bondholders been authorized to sell and transfer such property to the Company for and upon the consideration of the payment to the Bank as Trustee by the Company of Fifty Thousand Dollars ($50,000.00) and other good and valuable considérations, such Fifty Thousand Dollars ($50,000.00) to be payable in installments beginning April 15th, One thousand nine hundred and thirty-four, as represented by the promissory note of the Company in the following tenor and form, to-wit:

CLEVELAND, OHIO, *April 15, 1932.*

"For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

88 $2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941.

"Any unpaid portion of the said principal sum shall bear interest from April 15, 1932 at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

"This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

"As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by
89 the holder hereof against the latest maturing installments of the principal sum hereof.

"THE STRONG MANUFACTURING COMPANY,

"By: ----------

"President.

"Attest: ----------

"Secretary."

Whereas, said note is to be secured by a mortgage in the form hereof upon the said properties hereinafter described, which note and mortgage the Company has full power under its charter and under the laws of the State of Ohio to make;

NOW, THEREFORE, THIS INDENTURE WITNESSETH:

That for and in consideration of the premises and of the sum of One Dollar to it in hand paid by the Bank, receipt whereof is hereby acknowledged, and in order to secure the due and punctual payment of the principal and interest of the note hereby secured according to its tenor and of the covenants, promises and agreements in said note and herein contained, The Strong Manufacturing Company, party of the first part hereunder, does hereby give, grant, bargain, sell, convey, assign, transfer and set over unto Central United National Bank of Cleveland, its successors and assigns;

FIRST. All the following described real estate, lands and premises, situated in the Village of Sebring, County of Mahoning and State of Ohio,

"And known as being village lots Nos. 962 to 997 inclusive, according to the latest enumeration of lots in said Village, together with that part of outlot No. 33 which was formerly an alley and which was vacated by ordinance No. 141, and also that part of outlot No. 34 which was formerly part of Tennessee Avenue and which was vacated by ordinance No. 141, said lots forming a parcel of land having a frontage of 500 feet on the southerly side of California Avenue in said Village and
90 extending southerly therefrom along the westerly line of 18th Street, a distance of 453.2 feet to a fifteen foot alley; thence westerly along the northerly line of said fifteen foot alley a distance of 500 feet to the easterly line of 19th Street; thence northerly along the easterly line of 19th Street a distance of 464 feet to the southerly line of California Avenue.

"Subject to the rights or easements for the maintenance of two side tracks upon and over two strips of the above described property 15 feet in width, heretofore granted by The Strong Manufacturing Company to the Pennsylvania Company by deed dated October 18, 1913 and recorded in Vol. 188, Page 225 of Mahoning County Records.

"Together with all and singular the rights, privileges, hereditaments and appurtenances now or hereafter belonging or in anywise appertaining to the said above described premises."

SECOND. All offices, shops, factories, furnaces, warehouses, barns, buildings, structures and improvements now on said hereby conveyed premises or that may hereafter be erected or placed thereon.

THIRD. The manufacturing plant now owned by the Bank and located upon the land hereinabove described, together with any hereafter made improvements thereof and additions thereto, in-

cluding all railroad and railway tracks, industrial tracks, side tracks and sidings, elevators, conveyors, pipes and fittings, sprinkler system, heating system, machinery, shafting, belting, engines, boilers, kilns, furnaces, motors, electrical appliances, benches, boxes, trucks, scales, auto trucks, tools, implements, utensils, laboratory equipment, spare parts relating to plant equipment, trade and office fixtures and furniture, dies, drawings, patterns, and all other apparatus, appliances and equipment of every description now owned or that may hereafter be acquired or received by the Company.

FOURTH. Also, any and all property which may from
91 time to time hereafter by delivery or by writing of any kind be conveyed, assigned or transferred to the Bank by the Company or by any person or corporation to hold as part of the property herein mortgaged.

Provided, however, that nothing in this Indenture contained shall be deemed to apply to or cover the following property of the Company; cash on hand or in bank; securities, stocks, bonds, bills or notes and accounts receivable, trade acceptances receivable, advances to and accounts with agents and employees, advanced deposits in the usual course of business for water, gas and insurance, checks, raw material, material in process of manufacture or manufactured material and inventory, nor any other property ordinarily included under the term current assets.

To have and to hold the above described and hereby granted lands, premises, property, obligations, rights and assets unto the said Bank, its successors and assigns, upon the terms, covenants and conditions hereinafter set forth:

ARTICLE I

ANTICIPATION OF PAYMENTS UPON NOTE

(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified

in said note. The term "net earnings" as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes
92 payable in such year by the Company and fixed charges other than those created by the note hereby secured.

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured remain unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment; be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note.

Article II

Possession of Company and Releases of Property

(1) Until the default of the Company hereunder, made and continued as herein provided, the Company may in
93 any manner not affecting the lien of this Indenture, or not inconsistent with any of the specific provisions hereof, possess, operate, manage, and use the premises and property, together with the rents, issues and profits thereof as if this Indenture had not been made. The Company may, anything herein to the contrary notwithstanding, in its sole and absolute

discretion and without approval of the Bank, sell, assign, mortgage, pledge or otherwise dispose of and freely use in its business, any or all of its present or hereafter acquired cash, accounts receivables, merchandise, supplies, current assets and other property not hereby conveyed and the proceeds of any such disposition thereof, and the Company may give good and unencumbered title to any of such assets to any purchaser, pledgee or other acquirer thereof in all respects as if this Indenture had never been executed.

(2) Until the default of the Company, made and continued as herein provided, the Company may sell, exchange or otherwise dispose of, free from the lien hereof, and without the consent of the Bank, all such machinery, tools, equipment or other like tangible property as may have become worn out or unfit for use, or which, in its judgment, shall no longer be useful or necessary for the maintenance of its business and operations. In the event of default so made and continued, such right may be exercised with the written consent of the Bank. Any replacements made by the Company of any such machinery, tools or equipment so disposed of, shall thereupon become subject to the lien of this Indenture.

(3) If the premises and property herein conveyed to the Bank shall at any time be in the possession of a Receiver or Trustee in Bankruptcy, lawfully appointed, the powers herein and by this Article conferred upon the Company shall be exercised by such Receiver or Trustee, with the approval of the Bank.

Article III

PARTICULAR COVENANTS OF THE COMPANY

(1) The Company covenants and agrees as follows:

94 The Company shall and will pay the principal and interest specified in the note hereby secured, duly and punctually according to the terms thereof and of this Indenture.

(2) The Company shall and will pay and discharge, as the same become due and payable, all real estate, income, profits, franchise, personal and other taxes, water rates, assessments and charges lawfully levied and imposed by the United States or by any State, County, Municipality or other taxing authority upon the properties herein conveyed, and including the franchises, earnings, income, profits and business of the Company, and it shall not suffer any mechanics, laborers, statutory or other lien to remain outstanding against such property or any part thereof, the lien whereof might or could be held to be prior to the lien of this Indenture. In case of the failure of the Company to cause

such taxes or liens above mentioned to be discharged, the Bank shall have the right to pay and discharge such taxes or liens, and thereupon the Company shall, upon demand, repay to the Bank the amount so paid by it with interest at the rate of six per centum (6%) per annum upon the amount thereof from the time the same was paid by the Bank, and the amount of any such payments by the Bank, together with interest thereon shall until repaid be equally secured by this Indenture of Mortgage.

(3) The Company shall and will, subject to the provisions of Article II hereof, keep and maintain the properties herein conveyed in good repair, working order and first class condition, and fully supplied with all requisite machinery, motive power and equipment, and shall renew and replace the same when necessary. It shall and will also take all necessary steps to comply with the laws of the United States, the State of Ohio and of such other States as may now or hereafter be applicable, so as to preserve, obtain and secure the rights and privileges now or hereafter necessary or proper for the preservation of its corporate existence and the conduct of its business and affairs, all
95 with the intent that the premises, fixtures, machinery and buildings herein conveyed shall at all times constitute an active, going and operating manufacturing plant and be fit and proper for the purposes for which they were designed.

(4) The Company shall and will at all times, so long as any of the principal and interest hereby secured remains unpaid, keep the premises herein conveyed, insured against loss or damage by fire, to an amount usual and customary in similar classes of property, and it shall and will pay all premiums upon the policies for such insurance. All such policies shall be made payable to the Bank as its interest may appear and the Company, when so requested by the Bank, shall deposit all such policies with the Bank. Should the Company fail at any time to keep its properties so insured, the Bank may insure the same to such amount, in which event the Company, upon demand, shall and will repay to the Bank the amount of all premiums paid by it with interest at the rate of six percentum (6%) per annum upon the amounts so paid from the time of payment by the Bank, and such payments with interest thereon shall, until paid, be equally secured by the lien of this mortgage.

(5) The Company covenants and agrees forthwith upon the execution hereof to cause this Indenture to be duly and properly filed and recorded as a mortgage of real estate and also as a chattel mortgage, and to pay or cause to be paid all filing and recording fees. The Company shall and will from time to time execute, renew and refile such chattel mortgages as counsel may advise to be necessary to comply with the provisions of the laws

of the State of Ohio, so as to vest and/or keep vested in the Bank a chattel mortgage lien upon all such chattels now owned by the Company or hereafter acquired.

(6) The Company shall and will from time to time upon request in writing by the Bank, its successors or assigns, make, execute, and deliver at its own expense, all such further acts, deeds, conveyances, transfers, assignments, and other instruments for the better assuring to the Bank, its successors or assigns, for the
96 purposes herein expressed, all and singular the present and hereafter acquired premises and property hereby conveyed, as the Bank, its successors or assigns, being advised by counsel, shall reasonably require.

(7) The Company will not suffer or permit any default to occur under this Indenture, but will faithfully observe and perform all the conditions, covenants, and requirements hereof.

Article IV

REMEDIES ON DEFAULT.

(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1 hereof, and such default shall have continued for thirty (30) days; or shall make default other than one of the defaults herein specified, in respect of any condition, covenant, or agreement hereby required to be kept or performed by it, and such default shall have continued for sixty (60) days after written notice thereof to the Company from the Bank; or shall by decree of a court of competent jurisdiction be adjudicated a bankruptcy or insolvent, or by order of such court a receiver shall be appointed of the Company or of its property; or in any judicial proceeding by any party other than the Bank a judgment or order shall be entered by a court of competent jurisdiction for the sequestration of the property hereby conveyed or any part thereof, or the greater part of the Company's property shall be seized under any writ of attachment or other legal process and shall not be released or discharged therefrom by giving bond or otherwise within twenty (20) days; then, and in every such case, the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. In case the Company
97 shall fail upon demand to pay the same forthwith, the Bank shall be entitled to sue for and recover judgment for

the whole amount so due and unpaid with interest at the rate of six percentum (6%) per annum upon the overdue principal and installments of interest. No recovery of any such judgment by the Bank and no levy of execution upon any such judgment upon property subject to this Indenture or upon any other property shall in any manner or to any extent affect the lien of this Indenture upon any of the property subject hereto, or any rights, powers, or remedies of the Bank hereunder.

(2) No waiver by the Bank of any such default by the Company, whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom.

(3) If one or more of the events of default hereinabove specified shall happen, the Bank may enter upon and sell at public auction to the highest bidder, in the Village of Sebring, State of Ohio, or at such other place or places as may be required by law, and after giving such notice as may be required by law, the whole of the property herein mortgaged, in separate parcels or as an entirety, as the Bank may, in its discretion, deem advisable. The Bank may make or deliver to the purchaser or purchasers of the trust estate, good and sufficient deed or deeds thereof in fee simple, free from any incumbrances hereby created, which sale, made as aforesaid, shall be a perpetual bar, both at law and in equity, against the Company and all other persons claiming or to claim the said property, or any part thereof, by, from, through or under the Company, and the Bank, its successors and assigns are hereby appointed the true and lawful attorneys irrevocable of the Company, in its name and stead, for such purpose to execute all necessary acts of conveyance, assignment and transfer, the Company hereby ratifying and confirming all that its said attorneys shall lawfully do by virtue hereof. Any surplus remaining out of the proceeds of such sale after proper allowance for all expenses thereof, including attorney and
98 counsel fees, all other expenses or advances which may have been made or incurred by the Bank in respect to such property, the satisfaction of charges and liens prior to the lien of this Indenture on said property, and the full payment of the unpaid principal and interest upon this note hereby secured, shall be transferred and paid over to the Company, its successors or assigns, for its or their sole use and benefit.

(4) In case of any sale hereunder, the Bank may bid for and purchase the property sold, and upon compliance with the terms of sale, may hold and retain or dispose of such property without further accountability therefor to the Company.

(5) If one or more of the events of default shall happen, the Bank may, personally or by its attorney or agent, enter into and upon all and singular the property herein mortgaged and take possession thereof and wholly exclude the Company and its agents therefrom, and thereafter hold, use or operate the same as the Company could or might do if this Indenture had not been made, with the right to collect and receive all income, rents, issues and profits of the same, and after deducting the expense of operating such property and the cost of all materials, supplies, repairs, replacements and improvements, and payments on account of insurance, taxes or liens prior to the lien of this Indenture on the said property, or any part thereof, apply the remainder of such income in payment of any interest or principal then due and unpaid as specified in the note hereby secured. This power of entry may be exercised as often as occasion therefor shall arise until the principal and interest hereby secured have been fully paid.

(6) It is expressly understood that the rights of entry and sale and suit hereinbefore granted are intended as cumulative remedies, additional to each other and to all other remedies allowed by law, and that the same shall not be deemed in any manner whatever to deprive the Bank of any legal or equitable remedy by judicial proceeding or proceedings consistent with the provisions of this Indenture.

99 OCTOBER 15, 1936.

The conditions of the within mortgage have been complied with and the same is hereby satisfied and discharged.

CENTRAL NATIONAL BANK OF CLEVELAND,
Successor by change of name to
CENTRAL UNITED NATIONAL BANK OF CLEVELAND,

(Signed) By: H. R. HARRIS,
Vice President.

(Signed) ANTHONY POSS,
Trust Officer.

Recorded: Jan. 13, 1937.
JAMES M. ELLIOTT, *Recorder*
Mahoning County, Youngstown, Ohio.

(7) In case the Bank shall have proceeded to inforce any right under this Indenture by foreclosure, entry or otherwise, and such proceeding shall for any reason have been discontinued or abandoned, or shall have been determined adversely to the Bank, then and in every such case the Company and the Bank shall

be restored to their former position and rights hereunder in respect of the said premises, and all rights, remedies and powers of the Bank shall continue as though no such proceedings had been taken.

ARTICLE V

Defeasance

If the Company, its successors, or assigns shall well and truly pay, or cause to be paid, the whole amount of the principal and interest due upon the note hereby secured as in said note agreed to be paid, and if all the charges of the Bank hereunder or concerning the properties herein mortgaged shall have been paid or satisfied by the Company, and the Company shall have fully performed all its covenants and agreements hereunder, then and in that case the Company shall be entitled to have this Indenture satisfied and discharged, and all the properties hereby conveyed shall thereupon revert to the Company, or to its successors and assigns, and the estate, right, title and interest therein of the Bank, its successors and assigns, shall wholly cease, determine and become void. The Bank shall thereupon execute to the Company or to its successors and assigns, at the latter's cost and expense, such satisfaction, release, re-assignment and reconveyance as may be reasonably required to satisfy and discharge these presents, and shall pay over and deliver to the Company, or its successors or assigns, all money then in the hands of the Bank received by it under any provision of this Indenture, and all property held by it under any of the provisions hereof.

In witness whereof, The Strong Manufacturing Company, party of the first part, has caused its corporate name to be hereunto subscribed by its President, and its corporate seal affixed, attested by its Secretary; and Central United National Bank of Cleveland, Trustee, party of the second part, has caused its corporate name to be hereunto subscribed by its President or Vice-President and its corporate seal affixed, attested by its Cashier or an Trust Officer, as of the day and year first above written.

THE STRONG MANUFACTURING COMPANY,

[SEAL] By: (Signed) W. U. PFAEFFLI,
President.

Attest:

(Signed) T. F. SHAFFER,
Secretary.

Signed in the Presence of:
(Signed) R. A. BISHOP.
(Signed) W. N. GATES.

[SEAL] CENTRAL UNITED NATIONAL BANK,
Trustee,

By: (Signed) H. R. HARRIS,
Vice-President.

Attest:

(Signed) ANTHONY POSS,
Trust Officer.

(Signed) S. E. HART.
(Signed) J. L. MUNTYAN.

101 STATE OF OHIO,
Mahoning County, ss:

Before me, a Notary Public in and for the said County, personally came The Strong Manufacturing Company, a Corporation, by W. U. Pfaeffli, its President, and T. F. Shaffer, its Secretary, whose names respectively are signed to the foregoing instrument and who severally acknowledged the signing and execution of the said instrument for themselves respectively and for and on behalf of said Company, and acknowledged that they have affixed the corporate seal of said Company to said instrument and otherwise executed the same by direction of a Resolution of the Board of Directors of said Company, and who acknowledged that the same in all respects is their free act and deed as such officers respectively, and the free act and deed of said corporation.

In Testimony Whereof, I have hereunto set my hand and official seal at Youngstown, Ohio, this 18th day of April A. D. 1932.

[SEAL] (Signed) ARTHUR MORGAN,
Notary Public.

ARTHUR MORGAN,
Notary Public.

My commission expires July 8, 1932.

STATE OF OHIO,
Cuyahoga County, ss:

Before me, a Notary Public in and for the said County, personally came Central United National Bank, a banking corporation, by H. R. Harris, its Vice President, and Anthony Poss, its Trust Officer, whose names respectively are signed to the foregoing instrument and who severally acknowledged the signing and execution of the said instrument for themselves respectively and for and on behalf of said Bank, and acknowledged that they

have affixed the corporate seal of said Bank to said instrument and otherwise executed the same upon authority duly granted them, and acknowledged that the same in all respects is
102 their free act and deed as such officers respectively, and the free act and deed of said corporation.

In Testimony Whereof, I have hereunto set my hand and official seal at Cleveland, Ohio, this 18th day of April A. D. 1932.

[SEAL] (Signed) WILLIAM N. GATES,
Notary Public.

131 In United States Circuit Court of Appeals

Statement of points

Filed October 24, 1940

Comes now the petitioner on review herein and makes this concise Statement of Points on which he intends to rely on the review herein, to-wit:

The United States Board of Tax Appeals erred:

1. In holding and deciding that there is a deficiency in income tax for the year 1936 in the amount of $2,133.63.

2. In failing to sustain the deficiency in income tax determined by the Commissioner for the year 1936 in the amount of $14,776.89 less the proper reduction of said amount to reflect the adjustments agreed upon by the parties at the hearing before the Board of Tax Appeals.

3. In holding that "we are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, Michigan Silica Co., 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute."

4. In holding that the credit should have been allowed and that the Commissioner's determination to the contrary is overruled.

5. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

(Signed) J. P. WENCHEL,
CAR
Chief Counsel,
Bureau of Internal Revenue.

Service of a copy of the above statement of points is hereby acknowledged this 24th day of September, 1940.

(Signed) ARTHUR MORGAN,
(Signed) RAYMOND S. POWERS,
Counsel for Respondent on Review.

132 Before United States Board of Tax Appeals

Designation of portions of record, proceedings, and evidence to be contained in record on review

Filed October 24, 1940

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
   (a) Petition,
   (b) Answer to Petition.
3. Board's findings of fact, opinion, and decision.
4. Petition for review.
5. Notices of filing.
6. Statement of points.
7. This designation.

(Signed) J. P. WENCHEL,
CAR
Chief Counsel,
Bureau of Internal Revenue.

Service of a copy of the within designation of portions of record, proceedings, and evidence to be contained in record on review is hereby admitted this 1st day of October, 1940.

(Signed) RAYMOND S. POWERS,
Counsel for Respondent on Review.

133 [Clerk's Certificate to foregoing transcript omitted in printing.]

Before United States Board of Tax Appeals

Order Enlarging Time

On motion of counsel for the petitioner, it is

Ordered: That the time for preparation and transmission of the record *sur* petition for review of the above entitled proceed-

ing in the United States Circuit Court of Appeals for the Sixth Circuit, be and it is hereby extended to December 13, 1940.

[SEAL] (Signed) C. R. ARUNDELL,
Member.

Dated: Washington, D. C., October 9, 1940.

Now, November 27, 1940, the foregoing is certified from the record as a true copy.

(Signed) B. D. GAMBLE, *Clerk*,
U. S. Board of Tax Appeals.

134 In United States Circuit Court of Appeals
for the Sixth Circuit

Cause argued and submitted

November 11, 1941

Before HAMILTON, MARTIN, AND MCALLISTER, JJ.

This cause is argued by Bernard Chertcoff for Petitioner and by Raymond S. Powers for Respondent and is submitted to the court.

In United States Circuit Court of Appeals

Decree

Entered: December 9, 1941

Appeal from the United States Board of Tax Appeals.

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals and was argued by counsel.

On Consideration Whereof, It is now here ordered, adjudged, and decreed by this Court that the order or decree of the said Board of Tax Appeals in this cause be and the same is hereby affirmed.

136 In United States Circuit Court of Appeals, Sixth
Circuit

No. 8829

COMMISSIONER OF INTERNAL REVENUE, PETITIONERS

v.

THE STRONG MANUFACTURING COMPANY, RESPONDENT

On petition for Review of Decision of the United States Board of Tax Appeals.

Opinion

Filed Dec. 9, 1941

Before HAMILTON, MARTIN, and MCALLISTER, Circuit Judges.

MCALLISTER, Circuit Judge: The Commissioner of Internal Revenue filed his petition for review of the decision of the Board of Tax Appeals that The Strong Manufacturing Company was entitled to a credit on its 1936 surtax on undistributed profits by virtue of Section 26 (c) (2) of the 1936 Revenue Act.

The above mentioned section of the act, in so far as here applicable, provided that credits on undistributed profits shall be allowed to a corporation to the extent that earnings and profits are required to be irrevocably set aside within the taxable year for the discharge of a debt, provided they are so required to be set aside by written contract executed by the corporation prior to May 1, 1936. The taxpayer, an Ohio corporation, purchased its plant and equipment from the Central United National Bank of Cleveland about April 15, 1932, for the sum of $50,000. The purchase price was evidenced by a note, secured by a mortgage executed by the taxpayer to the bank, providing for payment in eight installments of varying amounts, due on April 15, 1934, and on the same date of each year thereafter. Stipulations
137 in the note set forth that the corporation could anticipate unpaid installments in whole or in part; and it was further provided in the note:

"In addition The Strong Manufacturing Company shall apply forty percent (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed."

The mortgage set forth:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply for per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor

of the regular interest payments in such year, likewise as specified in said note."

It was further provided that if the corporation defaulted, and such default continued for thirty days, the bank could declare the entire balance immediately due and payable; and no waiver of any default by the bank should affect any subsequent default.

In 1934, the taxpayer obtained from the bank a written extension on a then due installment of $2,000, principal, and $3,500, interest, on the note and mortgage. The extension was on the specific condition that it should not be considered a waiver of any subsequent defaults; and the bank did not waive or make any concession in respect to the covenants of the note and mortgage requiring the taxpayer to apply 40% of its net earnings in payment of the debt.

During 1936, the taxpayer made payments out of profits on the principal of the note, in various months, aggregating $46,500,
138 whereupon the bank waived payment of a small amount of principal and some interest, and accepted such payments in full for the balance due on the note and mortgage. The taxpayer claimed that these aggregate payments on the note and mortgage, which it made in 1936, are entitled to credit on undistributed profits and that by virtue of the provisions of the act, it is not taxable thereupon.

The relevant provisions of the statute read:

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

"(c) Contracts Restricting Payment of Dividends.

"(2) Disposition of Profits of Taxable Years.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressively deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

Petitioner insists that the contract did not require that respondent irrevocably set aside a portion of its earnings of the taxable year within that year for the discharge of the debt; and that in-

asmuch as the contract did not come within the required terms of the statute, respondent is entitled to no credit for the payments made.

The question, therefore, before us for determination, is whether the payments made by the corporation upon its debt are taxable as undistributed profits, or whether it is entitled to credit on the basis of earnings and profits "irrevocably set aside within the taxable year for the discharge of a debt."

In brief, the statute allows a deduction on the tax in question where a contract requires a corporation to set aside irrevocably a portion of its profits within the taxable year for the payment of a debt. In this case, the contract of the corporation re-
139 quires it to apply 40% of its net earnings for any calendar year to pay the balance of the debt, or a portion thereof, in that year. It is contended on behalf of the Commissioner that, because settlement on the debt could be made in the succeeding year, the contract does not require the irrevocable setting aside of such profits in the year in which they are earned. On the other hand, respondent corporation contends that, inasmuch as it is bound to "apply" its profits for the calendar year to the payment of the balance of the debt remaining unpaid in that year, this obligation comes within the requirement of the statute and constitutes a contract to set aside irrevocably a portion of its profits to the payment of a debt within a taxable year.

The phrase "set aside" has various meanings and connotations. One is "reserve"; and "reserve" is defined as "to keep back," "to retain," "to keep in store for future or special use," and "to retain or hold over to a future time"; "irrevocable" is defined as "incapable to being recalled or revoked." Webster's New International Dictionary. To sustain the respondent, we are required, however, to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain, or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax. Whether such a construction can properly be given the statute, and whether the conclusion reasonably follows that respondent is entitled to credit, depends upon accepted rules of statutory construction.

The construction of the statute for which the Commissioner contends would forbid credits to any corporation whose business

was such that it could not definitely ascertain its profits on the last day of the year; and this would exclude from such benefits all corporations that were obliged to take an inventory that could not be completed within the year. Obviously, the result would be to deny such credits to practically all manufacturing and merchandising corporations, and to admit only those financial companies whose earnings and profits are generally susceptible of immediate computation. This would be unjust. Payment
140 of the high surtax would work an unusual hardship on a corporation that was required, under penalty of mortgage foreclosure, to pay such earnings on its mortgage debts. Furthermore, the result of sustaining the claim of the Commissioner would be to require payment of a surtax on undistributed profits where there were no undistributed profits, by reason of the fact that the earnings, under inexorable conditions of a contract, were required to be paid upon a debt. This would be unjust and result in a burden of an especial and unusual nature.

Where a particular construction of a statute will produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. Constantine v. United States, 75 Fed. (2d) 928, Aff., 296 U. S. 287. The strict letter must yield to the evident spirit and purpose when necessary to give effect to the intent of Congress; Fleischmann Const. Co. v. United States, to use of Forsberg, 270 U. S. 349; for a thing which is within the intention of the statutes is as much within the statute as if it were within the letter, and a thing which is within the letter of the statute is not within the statute, unless it is within the intention of the maker; Northwestern Mutual Life Insurance Co. v. Gridley, 100 U. S. 614; and where the meaning is uncertain, a statute will be construed so as to avoid unnecessary hardship. Burnet v. Guggenheim, 288 U. S. 280. The duty of the court, being satisfied with the intention of the legislature, is to give effect thereto and not to defeat it by adhering too rigidly to the mere letter of the statute or to technical rules of construction. Oates v. First National Bank, 100 U. S. 239.

In the application of taxing statutes, substance and not form should control; Sanborn v. Commissioner of Internal Revenue, 88 Fed. (2d) 134, cer. den., 301 U. S. 700; and such laws should be construed and applied with a view of avoiding, as far as possible, unjust consequences. Farmers Loan and Trust Co. v. State of Minnesota, 280 U. S. 204.

In ascertaining the purpose of the legislature in enacting a statute, the court may examine its title and the legislative scheme or plan by which the object of the act is to be carried out; United

States v. Katz, 271 U. S. 354; and the intention is to be ascertained, not by taking a word or clause from its setting and viewing it apart, but by considering it in connection with the context, general purpose of the statute, occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will. Helvering v. Stockholms Enskilda Bank,
141 293 U. S. 84. The purpose of all statutory construction is to give effective to the legislature's intention and, hence, no rule of strict construction, which will defeat a statute's purpose, can be applied to its bare language.

The general title of the 1936 Revenue Act sets forth its purpose to "provide revenue, equalize taxation, and for other purposes." The subtitle of Section 26 (c) of the act reads: "Contracts restricting payment of dividends," and the title of Subsection 26 (c) (2) is: "Disposition of profits of taxable year." In the message of the President to Congress with respect to the enactment of the statute, the provisions of which are under consideration, he directed attention to a form of tax for the purpose of removing inequalities in the tax system, and mentioned, in this regard, the accumulation of surplus in corporations and the freedom of such undistributed corporate income from surtax. Message of President to Congress, March 3, 1936. In the report of the Ways and Means Committee of the House of Representatives on the Revenue Bill of 1936, after quoting the message, the Committee stated that the President had requested Congress to raise additional revenue by some form of undistributed profits tax, and that the Committee recognized that the greatest defect in the system of taxation at that time lay in the fact that surtaxes on individuals were avoided by impounding income in corporate surpluses. It was further recommended that corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenue of the United States and to the detriment of the shareholders, H. R. Rept. No. 2475, 74th Congress, Sec. Sess. From these proceedings, the legislative intention and the general purpose of the act, are obvious. It was sought to prevent corporations from accumulating tax free surplus arising out of their failure to distribute the earnings to shareholders, with the result that the Government could not tax such individuals. The headings in the statute, above referred to, indicate the intent to grant credit on surtax imposed on undistributed profits to the extent that such profits were not declared as dividends by reason of a contract requiring a different disposition of such profits.

It is necessary to keep in mind that taxation is an intensely practical matter and the substance of the thing done, and not

the form it takes, must govern. Commissioner of Internal Revenue v. Ashland Oil and R. Co., 99 Fed. (2d) 588 (C. C. A. 6); and that common sense interpretation is the safest rule to
142 follow in the administration of income tax laws. "Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes, men should measure both by ordinary, every-day business standards." Rhodes v. Commissioner of Internal Revenue, 100 Fed. (2d) 966, 969 (C. C. A. 6).

With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, accounting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.

We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to "apply" 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26 (c) (2) of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit.

That the profits, which were required to be applied to the indebtedness, could not be computed until after the taxable year, casts no doubt upon the conformity of the contract to the requirements of the statute. Where the law requires debts to be charged off within the taxable year, in order to receive deductions, the statutory language is construed to allow deductions for debts *physically* charged off in the first months of the succeeding year, in recognition of practical business necessities; and it is held that Congress did not intend that there should be any essential departure from the usual course of business in making book entries in order to comply with tax laws. *Hamlen* v. *Welch*, 116 Fed. (2d) 413 (C. C. A. 1); *Kentucky Rock Asphalt Co.* v. *Helburn*, 20 Fed. Supp. 364, Aff., 108 Fed. (2d) 779 (C. C. A. 6). Like principles are applicable to the ascertainment of profits, and credit for applications thereof on indebtedness.

143 The claim is advanced that because the duty to make certain regular stipulated payments did not, by contract,

depend on the existence of earnings, therefore, the taxpayer is not entitled to credit for such payments on the indebtedness. But the taxpayer is only seeking credit for that amount of profits which, in accordance with the contract, it claims it irrevocably set aside for payment of the debt. If the contract, with respect to the setting aside of such profits, conforms to the requirement of the statute, it is immaterial that the portion of profits so set aside for the indebtedness, exceeded the stipulated sum which was required to be paid, regardless of profits. That such required payment was included in the percentage of profits required to be set aside, has no bearing upon the right to credit.

We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp.* v. *Commissioner of Internal Revenue*, — Fed. (2d) — (C. C. A. 4) (decided November 10, 1941), it was held "that as an indispensable condition precedent to the allowance of the credit, the contract must in terms require that a part of the earnings and profits of the taxable year be irrevocably set aside within the taxable year." We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, *in terms*. With regard to the case of *Helvering* v. *Moloney Electric Co.*, 120 Fed. (2d) 617 (C. C. A. 8), in which it was held that the taxpayer was not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless.

In accordance with the foregoing, the decision of the Board of Tax Appeals is affirmed.

144 [Clerk's Certificate to foregoing transcript omitted in printing.]

145 Supreme Court of the United States

Order allowing certiorari

Filed April 6, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

146 In Supreme Court of the United States

Stipulation

Filed May 16, 1942

Subject to this Court's approval, it is hereby stipulated and agreed by and between the attorneys for the respective parties thereto, that for the consideration of this case on writ of certiorari, the printed record may consist of the following:

1. The material contained in the printed transcript of record (consisting of 141 pages) used for the purposes of the petition for writ of certiorari herein, omitting, however, the following:

(a) The entire transcript of testimony, pages 31–64, except the testimony of Sidney J. Collins at pages 52–57.

(b) Petitioner's Exhibit 1, appearing at pages 65–83.

(c) Petitioner's Exhibit 4, appearing at pages 102–105.

(d) Petitioner's Exhibit 5, appearing at pages 107–129.

2. This stipulation.

147 It is further agreed that either party may make reference in brief or argument to any portion of the record which is not included in the printed record prepared as aforesaid.

CHARLES FAHY,
Charles Fahy,
Solicitor General of the United States,
Counsel for Petitioner.

Dated this 11th day of May, 1942.

RAYMOND S. POWERS,
Counsel for Respondent.

Dated this 13th day of May, 1942.

File No. 46345. U. S. Circuit Court of Appeals, Sixth Circuit. Term No. 41. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. The Strong Manufacturing Company. Petition for a writ of certiorari and exhibit thereto. Filed March 5, 1942. Term No. 41, O. T. 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942

CLERK'S COPY.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 42

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

WARREN TOOL CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 5, 1942
CERTIORARI GRANTED APRIL 6, 1942



SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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1 Before United States Board of Tax Appeals

Docket No. 96406

WARREN TOOL CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances: For Taxpayer: John C. Morley, Esq., Paul W. Frum, Esq., R. T. Sawyer, Jr. Esq. For Commissioner: T. F. Callahan, Esq., DeWitt M. Evans, Esq.

Docket Entries

1938

Dec. 12—Petition received and filed. Taxpayer notified. (Fee paid.)

Dec. 12—Copy of petition served on General Counsel.

1939

Feb. 1—Answer filed by General Counsel.

Feb. 1—Request for Circuit hearing in Cleveland, Ohio, filed by General Counsel.

Feb. 4—Notice issued placing proceeding on Cleveland, Ohio, Calendar. Answer and request served.

Feb. 20—Notice of the appearance of Paul W. Frum as counsel filed.

Aug. 31—Hearing set Oct. 23, 1939, in Cleveland, Ohio.

2 Oct. 25—Hearing had before Mr. Opper, Div. 14, on the merits. Submitted. (Consolidated for hearing and decision with Docket No. 99552). Stipulation of facts filed. Appearance of R. T. Sawyer, Jr., filed. Briefs due 12/9/39; Replies 12/26/39.

Nov. 4—Transcript of hearing 10/25/39 filed.

Dec. 9—Brief filed by taxpayer. 12/11/39 copy served on General Counsel.

Dec. 9—Brief filed by General Counsel.

Dec. 28—Reply brief filed by taxpayer.

1940

June 17—Memorandum findings of fact and opinion rendered, Clarence V. Opper, Div. 14. Decision will be entered under Rule 50.

July 11—Computation of deficiency filed by General Counsel. Agreed to.

July 16—Decision entered, Clarence V. Opper, Div. 14.

Oct. 4—Petition for review by United States Circuit Court of Appeals, Sixth Circuit, with assignments of error filed by General Counsel.

Oct. 11—Proof of service filed by General Counsel.

1940
Nov. 4—Motion for extension of time to Jan. 2, 1941 to complete and transmit the record filed by General Counsel.
Nov. 4—Order enlarging time to Jan. 2, 1941 to complete and transmit the record, entered.
Nov. 22—Statement of points filed by General Counsel. Proof of service thereon.
Nov. 22—Designation of portions of record filed by General Counsel. Proof of service thereon.

3 Before United States Board of Tax Appeals

Docket No. 99552

WARREN TOOL CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances: For Taxpayer: Paul W. Frum, Esq., R. T. Sawyer, Jr., Esq. For Commissioner: T. F. Callahan, Esq., DeWitt M. Evans, Esq.

Docket entries

1939
July 17—Petition received and filed. Taxpayer notified. (Fee paid.)
July 17—Copy of petition served on General Counsel.
Aug. 17—Answer filed by General Counsel.
Aug. 17—Request for circuit hearing in Cleveland, Ohio, filed by General Counsel.
Aug. 21—Notice issued placing proceeding on Cleveland, Ohio, Calendar, Answer and request served.
Oct. 4—Hearing set Oct. 23, 1939, Cleveland, Ohio.
Oct. 25—Hearing had before Mr. Opper, Div. 14, on the merits. Submitted. Consolidated for hearing and decision with Docket 96406. Stipulation of facts filed. Appearance of R. T. Sawyer, Jr., filed.
4 Nov. 4—Transcript of hearing 10/25/39 filed.
Dec. 9—Brief filed by taxpayer.
Dec. 9—Brief filed by General Counsel.
Dec. 11—Copy of brief served on General Counsel.
Dec. 28—Reply brief filed by taxpayer.

1940
June 17—Memorandum findings of fact and opinion rendered, Clarence V. Opper, Div. 14. Decision will be entered under Rule 50.
July 11—Computation of deficiency filed by General Counsel. Agreed to.

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July 16—Decision entered, Clarence V. Opper, Div. 14.
Oct. 4—Petition for review by United States Circuit Court of Appeals, Sixth Circuit, with assignments of error filed by General Counsel.
Oct. 11—Proof of service filed by General Counsel.
Nov. 4—Motion for extension to 1/2/41 to prepare and transmit record filed by General Counsel.
Nov. 4—Order enlarging time to Jan. 2, 1941, to prepare and transmit the record, entered.
Nov. 22—Statement of points filed by General Counsel. Proof of service thereon.
Nov. 22—Designation of portions of record filed by General Counsel. Proof of service thereon.

5 Before United States Board of Tax Appeals

Petition—No. 96406

Filed December 12, 1938

Warren Tool Corporation, the taxpayer and the above-named petitioner, hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his deficiency letter (IRA:90D) bearing date September 17, 1938, and as the basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized and existing under the laws of the State of Ohio, with its principal office at Griswold Street Extension, Warren, Ohio.

2. The deficiency letter (copy of which is attached hereto and marked Exhibit A) was mailed to the petitioner on September 17, 1938, and states a deficiency in income tax for the taxable year ended December 31, 1936, in the sum of $3,037.25, together with interest thereon as provided by law, which is the tax and amount in controversy.

3. The determination of income tax and interest set forth in said deficiency letter is based upon the following errors:

(a) The Commissioner of Internal Revenue erred in disallowing the sum of $11,017.22 taken as a credit in determining undistributed net income in the computation of surtax on undistributed profits for the taxable year ended December 31, 1936, and the respondent erred in holding that said credit was not allowable in determining undistributed net income in the computation of surtax on undistributed profits for said year.

(b) The Commissioner of Internal Revenue erred in finding that undistributed net income for the purpose of computing surtax is $15,245.87 for the year 1936, and erred in failing to

find that the petitioner had no undistributed net income subject to surtax for said year.

(c) The Commissioner of Internal Revenue erred in finding that a deficiency in surtax of $1,883.38 with interest existed in consequence of failing to allow the credit mentioned in sub-paragraph (a) hereof, and in finding additional income as
6 mentioned in sub-paragraphs (d) and (e) hereof, and erred in failing to find that there was no deficiency in surtax for said year.

(d) The Commissioner of Internal Revenue erred in disallowing the sum of $974.83 on account of depreciation for the year 1936, and erred in failing to find that said deduction for depreciation was allowable in determining taxable net income for said year.

(e) The Commissioner of Internal Revenue erred in disallowing the sum of $6,025.30 for development expense for the year 1936, and erred in failing to find that the deduction for development expense was allowable in determining taxable net income for said year.

(f) The Commissioner of Internal Revenue erred in finding that the petitioner had taxable net income of $47,674.55 for the year 1936, and erred in failing to find that the petitioner had taxable net income of $39,979.27 for said year.

(g) The Commissioner of Internal Revenue erred in finding that a deficiency of income tax of $3,037.25 with interest existed for the year 1936 in consequence of failing to allow the credit mentioned in sub-paragraph (a) hereof, the allowance for depreciation mentioned in sub-paragraph (d) hereof, and development expense mentioned in sub-paragraph (e) hereof, and erred in failing to find that there was no deficiency in income tax for said year.

4. The facts upon which the petitioner relies as the basis for its proceeding herein are as follows:

(a) Pursuant to Article IV of the First Mortgage and Deed of Trust between Warren Tool Corporation and The Cleveland Trust Company, Trustee, dated November 1, 1932, the petitioner, out of its earnings for 1936, purchased $12,000. aggregate principal amount of its bonds at par plus accrued interest, turned them in to The Cleveland Trust Company, Trustee, pursuant to Article IV of the First Mortgage and Deed of Trust, and such bonds were cancelled by The Cleveland Trust Company, Trustee, prior to December 31, 1936. The taxpayer avers
7 that in consequence of this action it took a credit of $11,017.22 on its tax return for 1936, as a credit claimed under Section 26 (c) (2) of the Revenue Act of 1936, in com-

puting its undistributed net income for said year 1936; that it had no such undistributed net income whatever, and consequently none upon which a surtax could or should have been assessed.

(b) The petitioner charged on its books as an expense in the year 1936, the sum of $974.83, as depreciation on demolished drop hammer foundations and buildings, by reason of these facts:

The entire undepreciated portion of said demolished drop hammer foundations and buildings had been reported by the petitioner as an expense for the taxable year ended December 31, 1935, in its income tax return for 1935. The respondent disallowed these items as an expense for 1935, required them to be restored to the petitioner's books and the cost thereof recovered by depreciation. In November, 1936, the petitioner carried out these requirements of the respondent by appropriate entries on the books of the petitioner and by payment of a deficiency assessment for the year 1935. The amount of $974.83 is depreciation on said items for the year 1936.

(c) The petitioner charged on its books as an expense in the year 1936, the sum of $6,025.30, as experimental expense in connection with the development of a wrecking bar machine, which was completed during said year, and reported this amount as an expense in its income tax return for 1936. It was fully and finally determined by the petitioner in 1936 that the item of $6,025.30 was fully and finally expense by the petitioner in the year 1936, and should not properly be capitalized and recovered by depreciation.

Wherefore, the petitioner respectfully prays that the Board may hear and determine its appeal, and further prays that the Board may find that the petitioner owes no additional
8 income taxes for the year ended December 31, 1936, and that the Board may grant such other and further relief as the nature of the case may warrant.

JOHN C. MORLEY,
Counsel for the Petitioner,
1956 Union Commerce Building,
Cleveland, Ohio.

Of Counsel:

BAKER, HOSTETLER & PATTERSON,
1956 Union Commerce Building, Cleveland, Ohio.

[*Duly sworn to by Paul W. Frum; jurat omitted in printing.*]

9 *Exhibit A to petition*

CLEVELAND
IRA:90D

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
Cleveland, Ohio, September 17, 1938.

WARREN TOOL CORPORATION,
Griswold Street Extension, Warren Ohio.

GENTLEMEN: You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1936 discloses a deficiency of $3,037.25, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 415 Hanna Building, Cleveland, Ohio, Attention IRA:90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,
By R. C. CAKE,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.

10 STATEMENT

In re: Warren Tool Corporation, Griswold Street Extension, Warren, Ohio

TAX LIABILITY FOR TAXABLE YEAR ENDED DECEMBER 31, 1936

INCOME TAX

1936, Liability, $7,874.56. Assessed, $4,837.31. Deficiency, $3,037.25.

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated November 15, 1937; to your protest dated April 6, 1938; and to the statements made at the conference held on May 20, 1938.

In filing your return for 1936, a credit of $11,017.22 was claimed in determining undistributed net income in the computation of surtax on undistributed profits. The credit was claimed under Section 26 (c) (2) of the Revenue Act of 1936 and was based on a contract dated November 1, 1932, which you allege restricted the payment of dividends.

It appears that you were organized on October 11, 1932, and that on or about that date you acquired the properties of the bankrupt Warren Tool and Forge Company. An issue of $100,000.00 First Mortgage 10-year 6% Gold Bonds were authorized, of which $68,000.00 was issued. The bond indenture dated November 1, 1932 provided as follows:

"For the purpose of creating the sinking fund for the redemption of the bonds issued hereunder, the company hereby agrees to pay to the trustee on or before the first day of April 1935 and on or before the first day of April of each year thereafter, to and including April 1, 1942, a sum of money equal to 25% of its net earnings for the calendar year next preceding."

11 None of the outstanding bonds had been retired prior to the year 1936, and during that year the entire amount of $68,000.00 was purchased by you for cash. In order to finance the purchase, you borrowed $50,000.00 on December 1, 1936 from The Second National Bank of Warren, Ohio, and gave five notes for $10,000.00 each, payable annually on December 1, 1937 to 1941, inclusive. Bonds in the amount of $50,000.00 were posted as collateral on the notes and as the notes are paid off a like amount of bonds are to be returned to you and cancelled. Under your arrangements with the bank you are required to deposit in a special account $250.00 weekly, which amount is to be used to pay off the notes as they fall due.

It appears that the bond indenture was superseded by a new agreement dated December 1, 1936. It further appears that during the taxable year 1936 cash dividends of $26,437.50 were paid by you to your stockholders. The payments which were required under the bond indenture were not according to the provisions of said mortgage required to be made out of the earnings and profits of the taxable year. The same holds true with respect to the payments required under the provisions of the new agreement dated December 1, 1936. The credit of $11,017.22 as claimed under Section 26 (c) (2) of the Revenue Act of 1936 has therefore been disallowed.

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1936

Net income as disclosed by return		$39,979.27
Unallowable deductions:		
(a) Taxes decreased	$424.40	
(b) Depreciation decreased	974.83	
(c) Development expense	6,025.30	
(d) Reserve for discounts	270.75	7,695.28
Net income adjusted		$47,674.55

12 EXPLANATION OF ADJUSTMENTS

(a) The deduction claimed for taxes has been decreased $424.40. Ohio real estate taxes for the year 1936 claimed in the amount of $1,372.26 have been decreased to $1,013.86, the amount actually paid for that year. Federal capital stock tax of $805.00 as claimed has been increased to $814.00, the amount of tax for the year ended June 30, 1937, which accrued on July 1, 1936. Income tax of $75.00 paid on bond interest is not a proper deduction from gross income and therefore has been eliminated. These adjustments result in a decrease in the amount claimed for taxes of $424.40.

(b) Depreciation of $8,637.92 as claimed has been decreased to $7,663.09, resulting in an increase in net income of $974.83.

(c) The expense incurred in the development of a wrecking bar machine, which was charged to operations in the amount of $6,084.95, has been disallowed as a deduction as a patent covering this machine was issued to you on October 27, 1936. The amount disallowed represents the cost of the patent, and a deduction for amortization has been allowed for the taxable year 1936 of $59.65 based on seventeen years, the life of the patent. These adjustments result in an increase in net income of $6,025.30.

(d) The reserve for quantity discounts at December 31, 1935,

showed a balance of $9,926.94 and at December 31, 1936, a balance of $1,000.00. The decrease in the reserve of $8,926.94 was claimed as a deduction in filing your return in operating expenses. It appears that during the year 1936 $270.75 was transferred from the reserve and credited to surplus account. Therefore, the deduction claimed has been decreased by the latter amount.

Computation of Tax

Taxable Year Ended December 31, 1936

INCOME TAX

Normal Tax

	Taxable net income	$47,674.55
13	Less: Excess-profits tax	None
	Net income for normal tax computation	$47,674.55
8%	of $ 2,000.00	$160.00
11%	of $13,000.00	1,430.00
13%	of $25,000.00	3,250.00
15%	of $ 7,674.55	1,151.18
	Total normal tax	$5,991.18

SURTAX ON UNDISTRIBUTED PROFITS

Taxable net income			$47,674.55
Less:			
	Excess-profits tax	None	
	Normal tax	$5,991.18	5,991.18
	(a) Adjusted net income		$41,683.37
Less:			
	Dividends paid credit	$26,437.50	
	Credit for contract restricting dividend payments	None	26,437.50
	(b) Undistributed net income		$15,245.87
Less:	Specific credit		831.66
	(c) Remainder subject to surtax		$14,414.21
7%	of $4,168.34		$291.78
12%	of $4,168.33		500.20
17%	of $6,077.54		1,033.18
	Amount of Tax		$1,825.16
Plus:	7% of $831.66 (Specific credit)		58.22
	Total surtax		$1,883.38
14	Normal tax		5,991.18
	Total income tax (normal tax and surtax)		$7,874.56
Income tax assessed (normal tax and surtax):			
	Original, account No. 400494		4,837.31
	Deficiency of income tax		$3,037.25

Before United States Board of Tax Appeals

Petition—No. 99552

Filed July 17, 1939

Warren Tool Corporation, the taxpayer and the above-named petitioner, hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his deficiency letter (IRS:90D) bearing date June 27, 1939, and as the basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized and existing under the laws of the State of Ohio, with its principal office at Griswold Street Extension, Warren, Ohio.

2. The deficiency letter (copy of which is attached hereto and marked Exhibit A) was mailed to the petitioner on June 27, 1939, and states a deficiency in income tax for the taxable year ended December 31, 1937, in the sum of $3,193.53, together with interest thereon as provided by law, of which $2,076.37, being additional surtax for such year, is the tax and amount in controversy.

3. The determination of income tax and interest set forth in said deficiency letter is based upon the following errors:

(a). The Commissioner of International Revenue erred in disallowing the sum of $13,053.52 taken as a credit in determining undistributed net income in the computation of surtax on undistributed profits for the taxable year ended December 31, 1937, and the respondent erred in holding that said credit was not allowable in determining undistributed net income in the computation of surtax on undistributed profits for said year.

(b) The Commissioner of Internal Revenue erred in finding that undistributed net income for the purpose of computing surtax is $20,640.35 for the year 1937, and erred in failing to find that the petitioner had undistributed net income subject to surtax for said year in the sum of $7,586.82.

(c) The Commissioner of Internal Revenue erred in finding that a deficiency in surtax of $2,725.65 with interest existed in consequence of failing to allow the credit mentioned in sub-paragraph (a) hereof, and erred in failing to find that the deficiency in surtax for said year was $649.35 with interest.

(d) The Commissioner of Internal Revenue erred in finding that a deficiency of income tax of $3,193.53 with interest existed for the year 1937 in consequence of failing to allow the credit mentioned in sub-paragraph (a) hereof, and erred in failing to find that there was a deficiency of income tax for said year of $1,117.16 with interest.

4. The facts upon which the petitioner relies as a basis for its proceeding herein are as follows:

(a) Pursuant to Article IV of the First Mortgage and Deed of Trust between Warren Tool Corporation and The Cleveland Trust Company, Trustee, dated November 1, 1932, the petitioner, out of its earnings for 1937, purchased $14,000. aggregate principal amount of its bonds at par plus accrued interest, turned them in to The Cleveland Trust Company, Trustee, pursuant to Article IV of the First Mortgage and Deed of Trust and such bonds were cancelled by The Cleveland Trust Company, Trustee, prior to December 31, 1937. The taxpayer avers that in consequence of this action it had and took as a credit $13,053.52 on its tax return for 1937, as a credit claimed under Sec-
16 tion 26 (c) (2) of the Revenue Act of 1937, in computing its undistributed net income for said year 1937; that it had undistributed net income for said year of $7,586.82 upon which a surtax of $649.35 with interest should have been assessed.

Wherefore, the petitioner respectfully prays that the Board may hear and determine its appeal, and further prays that the Board may find that the petitioner owes additional income taxes for the year ended December 31, 1937, only in the amount of $1,117.16 with interest, and that the Board may grant such other and further relief as the nature of the case may warrant.

PAUL W. FRUM,
Counsel for the Petitioner,
1956 Union Commerce Building,
Cleveland, Ohio.

Of Counsel:
BAKER, HOSTETLER & PATTERSON,
1956 Union Commerce Building, Cleveland, Ohio.

[*Duly sworn to by Thorn Pendleton; jurat omitted in printing.*]

17 *Exhibit A to petition*

TREASURY DEPARTMENT

INTERNAL REVENUE SERVICE

415 Hanna Building

CLEVELAND, OHIO, *June 27, 1939.*

CLEVELAND
IRA:90D

WARREN TOOL CORPORATION,
Griswold Street Extension, Warren, Ohio.

SIRS: You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1937 discloses a deficiency of $3,193.53 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Cleveland, Ohio, for the attention of IRA:90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.

By R. C. CAKE,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of waiver.

18 STATEMENT

CLEVELAND
IRA: 90D

In re: Warren Tool Corporation, Griswold Street Extension, Warren, Ohio

TAX LIABILITY FOR THE TAXABLE YEAR ENDED DECEMBER 31, 1937

Income Tax: Liability, $10,575.20. Assessed, $7,381.67. Deficiency, $3,193.53.

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated November 1, 1938; and to your protest dated February 13, 1939.

Your representative, Mr. Paul W. Frum, advised this office that a conference in the matter was not desired, therefore, the statutory notice of deficiency is being issued at this time.

In filing your return for 1936, a credit of $14,000.00 was claimed in determining undistributed net income in the computation of surtax on undistributed profits. The credit was claimed under Section 26 (c) (2) of the Revenue Act of 1936 and was based on a contract dated November 1, 1932, which you allege restricted the payment of dividends. It appears that you were organized on October 11, 1932 and that on or about that date you acquired the properties of the bankrupt Warren Tool and Forge Company. An issue of $100,000.00 First Mortgage Ten Year 6% Gold Bonds was authorized, of which $68,000.00 was issued. The bond indenture, dated November 1, 1932, provided as follows:

"For the purpose of creating the sinking fund, for the redemption of the bonds issued hereunder, the company hereby agrees to pay to the trustee on or before the first day of April, 1935, and on or before the first day of April of each year thereafter, to and including April 1, 1942, a sum of money equal
19 to 25% of its net earnings for the calendar year next preceding."

None of the outstanding bonds had been retired prior to the year 1936 and during that year the entire amount of $68,000.00 was purchased by you for cash. In order to finance the purchase, you borrowed $50,000.00 on December 1, 1936 from the Second National Bank of Warren, Ohio, and gave five notes for $10,-

000.00 each, payable annually on December 1, 1937 to 1941, inclusive. Bonds in the amount of $50,000.00 were posted as collateral on the notes and as the notes are paid off a like amount of bonds are to be returned to you and cancelled. Under your arrangements with the bank, you are required to deposit in a special account $250.00 weekly, which amount is to be used to pay off the notes as they fall due.

During the taxable year 1937, the sum of $14,000.00 was paid by you into the special account, which amount was claimed as a credit under Section 26 (c) (2) of the Revenue Act of 1936.

It appears that the bond indenture was superseded by a new agreement dated December 1, 1936. It further appears that during the taxable year 1936 dividends of $31,573.75 were paid by you to your stockholders. The payments which were required under the bond indenture were not according to the provisions of said mortgage required to be made out of the earnings and profits of the taxable year. The same holds true with respect to the payments required under the provisions of the new agreement dated December 1, 1936. The credit of $14,000.00, as claimed under Section 26 (c) (2) of the Revenue Act of 1936, has, therefore, been disallowed.

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1937

	Net income as disclosed by return		$55,611.59
20	Unallowable deductions:		
	(a) Reserve for Quantity Discounts	$4,186.18	
	(b) Capital stock tax	14.00	
	(c) Taxes decreased	251.88	4,452.06
	Net income adjusted		$60,063.65

EXPLANATION OF ADJUSTMENTS

(a) You claimed a deduction of $4,186.18 for quantity discounts representing the increase in the reserve account during the taxable year 1937. As the amount accrued and set up in reserve is not an actual and determined liability, it does not constitute a proper deduction for income tax purposes and, therefore, has been disallowed.

(b) Capital stock tax of $814.00, as claimed, has been decreased to $800.00, resulting in an increase in net income of $14.00.

(c) The deduction claimed for taxes on real estate and personal property was overstated by $251.88.

COMPUTATION OF TAX

Taxable Year Ended December 31, 1937

INCOME TAX

Normal Tax

Taxable net income	$80,063.65
Less: Excess-profits tax	None
Net income for normal tax computation	$80,063.65
8% of $2,000.00	$160.00
11% of $13,000.00	1,430.00
13% of $25,000.00	3,250.00
15% of $20,063.65	3,009.55
Total normal tax	$7,849.55

21 SURTAX ON UNDISTRIBUTED PROFITS

Taxable net income		$80,063.65
Less:		
Excess-profits tax	None	
Normal tax	$7,849.55	7,849.55
(a) Adjusted net income		$52,214.10
Less: Dividends paid credit		31,573.75
(b) Undistributed net income		$20,640.35
7% of $5,221.41		$365.50
12% of $5,221.41		626.57
17% of $10,197.58		1,733.58
Total Surtax		$2,725.65
Normal tax		7,849.55
Total income tax (normal tax and surtax)		$10,575.20
Income tax assessed (normal tax and surtax): Original, account No. 402853		7,381.67
Deficiency of income tax		$3,193.53

22 Before United States Board of Tax Appeals

Answer—No. 96406

Filed February 1, 1939

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and in answer to the petition in the above-entitled proceeding, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3 (a) to (g), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (g), inclusive of paragraph 3 of the petition.

4 (a) to (c), inclusive. Denies the allegations of fact contained in subparagraphs (a) to (c), inclusive of paragraph 4 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the appeal be denied.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
DEWITT M. EVANS,
Division Counsel,
THOS. F. CALLAHAN,
Special Attorney,
Bureau of Internal Revenue.

23 Before United States Board of Tax Appeals

Answer—No. 99552

Filed August 17, 1939

Comes now, the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue and for answer to the petition filed herein admits and denies as follows:

1. Admits the allegations contained in Paragraph 1 of the petition.

2. Admits that a deficiency letter was mailed to the petitioner on June 27, 1939, showing a deficiency in income tax for the taxable year ended December 31, 1937, in the sum of $3,193.53, together with interest thereon as provided by law, but denies the remaining allegations of Paragraph 2 of the petition.

3, (a) to (d), inclusive. Denies that the Commissioner erred in the manner and form, as alleged in subparagraphs (a) to (d), inclusive of Paragraph 3 of the petition.

4 (a). Denies the allegations contained in subparagraph (a) of Paragraph 4 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the appeal be denied.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
P. M. CLARK,
Acting Division Counsel.
THOS. F. CALLAHAN,
Special Attorney,
Bureau of Internal Revenue.

24 Before United States Board of Tax Appeals

WARREN TOOL CORPORATION, GRISWOLD STREET EXTENSION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket Nos. 96406 and 99552

John C. Marley, Esq., Paul W. Frum, Esq., and R. T. Sawyer, Jr., Esq., for the petitioner.

DeWitt M. Evans, Esq., and Thomas F. Callahan, Esq., for the respondent.

Memorandum findings of fact and opinion

(Entered June 17, 1940)

OPPER: Respondent determined deficiencies in petitioner's income tax for the years 1936 and 1937 in the amounts of $3,037.25 and $3,193.53, respectively.

Petitioner assails respondent's action on the grounds that it was entitled to credit under section 26 (c) (2) of the Revenue Act of 1936, because of a contract requiring it to make payments to a sinking fund for the redemption of bonds issued by it, and was entitled to deductions for depreciation and development expenses for the year 1936.

FINDINGS OF FACT

All of the facts were stipulated and are so found. As far as pertinent for present purposes they are as follows:

Petitioner, an Ohio corporation, on November 1, 1932, executed a first mortgage and deed of trust to the Cleveland Trust Company (hereinafter called the trustee) securing bonds issued on that date in the amount of $300,000. Between November 1, 1932,

$5 C. C.C.

and January 1, 1935, an additional $18,000 of bonds were issued, and on January 1, 1935, $68,000 of bonds were outstanding. The bonds bore interest at the rate of 6 percent per annum.

The sinking fund provision in the mortgage was in part as follows:

25 "ARTICLE IV. Sinking Fund

"Section 1. For the purpose of creating the sinking fund for the redemption of the bonds issued hereunder, the Company hereby agrees to pay to the Trustee on or before the 1st day of April, 1935, and on or before the 1st day of April of each year thereafter to and including April 1, 1942, a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding. * * * The Company may, in lieu of depositing cash in whole or in part, purchase bonds issued hereunder at a price not exceeding the redemption price thereof as fixed by the provisions of Article V hereof, and deliver such bonds to the Trustee for credit against said sinking fund obligations to the extent of the purchase price (excluding the accrued interest) paid therefor by the Company. * * * Prior to the first day of April in each year abovementioned, the Company shall also file with such Trustee a statement sworn to by one of such officers showing the amount of the Company's net earnings for the preceding calendar year computed in the manner hereinbefore provided and duly certified by such accountant or accountants."

Petitioner for the calendar year 1934 had no net earnings as determined by its accountant in the manner provided in the above quoted section, and petitioner so advised the trustee by letter dated March 30, 1935.

Petitioner for the calendar year 1935 had net earnings, within the meaning of the above quoted section, in the amount of $15,020.84 and owed the trustee $3,755.21 for the sinking fund. It so advised the trustee by certified letter dated March 23, 1936.

Considering the sinking fund requirement, petitioner purchased on or about March 23, 1936, out of its net earnings for 1935, from the holders thereof, $5,500 of its first mortgage bonds and on that date delivered them to the trustee. The trustee cancelled,
26 discharged and cremated the bonds and applied them against the sinking fun requirements, which amounted to $3,755.21, as shown above.

On or about December 3, 1936, petitioner's accountant estimated that petitioner's net earnings, under the above quoted section of the mortgage, would be about $50,000. It delivered to the trustee $12,500 of its first mortgage bonds, for which it had paid

$12,755. These bonds had been purchased from their holders between November 9, 1936, and December 3, 1936, and were not a part of the $50,000 of bonds deposited with The Second National Bank of Warren as hereinafter described. These bonds were delivered in consideration of the sinking fund requirement and were cancelled and cremated by the trustee.

On February 10, 1937, petitioner certified to the trustee that its net earnings for the calendar year ending December 31, 1936, were $44,068.90, and therefore the payment owed to the trustee was $11,017.22, which had been satisfied as above related.

By letter dated November 9, 1936, petitioner offered to borrow from The Second National Bank of Warren, Warren, Ohio, the sum of $50,000 payable in five successive annual installments at $10,000 each, the first payment to be due on or before December 31, 1937.

The terms of this transaction, which were agreed to by the bank, appeared in the above described letter of November 9, 1936, and were in part as follows:

* * * * *

"1. Immediately upon the acceptance of this offer we will purchase all of our First Mortgage Ten Year Six Per Cent Gold Bonds which are now outstanding in the aggregate principal amount of $62,500.

"2. We will tender to The Cleveland Trust Company as Trustee, for cancellation and discharge, $12,500. of such bonds, leaving $50,000. of such bonds in our treasury.

"3. We will execute and deliver to you on or before
27 December 1, 1936, five (5) promissory notes dated December 1, 1936, payable to your order, each note in the principal amount of $10,000., as follows:

* * * * *

"4. We will secure said notes by depositing with you our bonds in the principal amount of $50,000., with 10,000. of such bonds to be released and redelivered by you to us for cancellation and discharge each time one of said notes is fully paid, and with interest coupons to be collected by us so long as such notes are not in default.

"5. We agree that if, without your consent, we issue any more of said bonds, or mortgage, sell, pledge or assign any of our property rights or franchises while any of the notes referred to herein are outstanding, or default in the payment of principal or interest on any of said notes, said notes shall forthwith become due and payable at your option.

"6. We are enclosing herewith a copy of a First Mortgage and Deed of Trust dated November 1, 1932, between Warren Tool

Corporation and The Cleveland Trust Company, Trustee, securing said bonds, and we agree upon request by you to enter into a supplemental agreement with The Cleveland Trust Company, Trustee, so that if we default in the payment of any of said notes it shall be considered an 'event of default' under Section 1, Article VI, of said First Mortgage and Deed of Trust."

* * * * * *

On the receipt of this loan of $50,000 on or about December 3, 1936, petitioner paid the trustee for the Pendleton Estates $48,000 for a like amount of its first mortgage bonds. Contemporaneously, this $48,000 of bonds were delivered at petitioner's order to The Second National Bank of Warren to be held by it under the terms above quoted and a trilateral agreement between petitioner, The Second National Bank, and the trustee, as shown
28 in a letter from petitioner to the trustee and The Second National Bank dated December 1, 1936, which stated as follows:

"In connection with the First Mortgage and Deed of Trust dated November 1, 1932 between Warren Tool Corporation and The Cleveland Trust Company, Trustee, (Mortgage) securing an issue of $100,000. First Mortgage Ten Year Six Per Cent Gold Bonds of Warren Tool Corporation (Bonds), and in consideration of a loan of $50,000. to be made to the undersigned, Warren Tool Corporation, by The Second National Bank of Warren, Ohio, we hereby represent, warrant, covenant and agree with you, jointly and severally, as follows:

"1. Under the Mortgage and aggregate principal amount of $68,000. of such Bonds have been authenticated, issued and delivered. $18,000. aggregate principal amount of such bonds have been surrendered to The Cleveland Trust Company for cancellation and discharge, and have been cancelled and discharged. $48,000. aggregate principal amount of said bonds are now held by us in treasury, and $2,000. aggregate principal amount of said bonds are held by S. K. Hine. The $48,000. of bonds held by us in treasury are to be delivered by us immediately to The Second National Bank of Warren as collateral security for the loan above referred to, and S. K. Hine has agreed to deliver the bonds held by him to The Second National Bank of Warren as collateral security for the loan above referred to on or about May 15, 1937, against payment thereof with interest accrued to the date of deposit, the amount of which principal and accrued interest has been deposited by us with The Second National Bank of Warren.

"2. Upon execution by Henry Pirtle as Trust Officer of The Cleveland Trust Company of an affidavit of good faith in
29 the form hereto attached, we will forthwith file a copy of

the Mortgage with such affidavit of good faith attached as a chattel mortgage, with the Recorder of Trumbull County, Ohio.

"3. We hereby authorize and instruct The Second National Bank of Warren, its successors and assigns, in the event we default in the payment of any of the notes evidencing said loan, or otherwise default in the performance of any of the terms and conditions of our loan agreement with The Second National Bank of Warren, to give written notice to The Cleveland Trust Company as Trustee to forthwith declare the principal of all of the Bonds then outstanding, if not already due, to be forthwith due and payable, in accordance with Section 2 of Article VI of the Mortgage, and we hereby authorize and instruct The Cleveland Trust Company as Trustee to act upon such notice from The Second National Bank of Warren, and without investigation of whether in fact a default has occurred in said notes or in said loan agreement, to declare the principal of said Bonds then outstanding, if not already due, to be forthwith due and payable, pursuant to Section 2, Article VI, of the Mortgage, and thereafter to take any and all actions and do any and all things authorized or permitted to be done under Article VI, 'Remedies upon Default', of said Mortgage."

Aside from the $50,000 received from The Second National Bank, petitioner did not have sufficient cash or quick assets to use for this purpose.

On or about December 3, 1936, petitioner deposited $2,060 with The Second National Bank of Warren for the purpose of paying S. K. Hine the principal amount of his bonds and interest to May 1, 1937, it being contemplated that Hine would return from Florida in May 1937 and be able to make delivery of his $2,000 in bonds. On or about May 7, 1937, Hine did surrender his $2,000 in bonds to The Second National Bank of Warren. The $50,000 of bonds were thereafter held by The Second National Bank of Warren as collateral security for the obligations evidenced by the five promissory notes dated December 1, 1936.

On or about December 2, 1937, petitioner's accountant estimated that its net earnings under the mortgage for the calendar year 1937 would be about $50,000. It delivered to the trustee $10,000 of its first mortgage bonds, for which it had paid $10,000. These bonds had been redelivered to petitioner by The Second National Bank of Warren on or about December 1, 1937, upon petitioner paying that bank the first $10,000 note which was due December 1, 1937. These bonds were cancelled and cremated by the trustee.

On or about December 28, 1937, petitioner, upon reconsideration of the matter, estimated that its net earnings for the calendar year 1937 would be about $52,000, based on the accountant's revised report. It delivered to the trustee $4,000 more of its first mortgage bonds on December 28, 1937, for which it had paid $4,000. These bonds had been redelivered to petitioner by The Second National Bank of Warren on or about December 28, 1937, upon petitioner paying that bank $4,000 on the second $10,000 which was due December 1, 1938. These bonds were cancelled and cremated by the trustee.

The net earnings of petitioner for the year 1937 were thereafter determined by its accountant to be $52,214.10, and therefore of the $14,000 of its first mortgage bonds deposited in December, 1937, $13,053.52 were one-fourth of the net earnings.

In December 1938, petitioner pursued the same method of operation as described above for the years 1936 and 1937.

During the taxable years in question petitioner made its income tax returns upon an accrual basis.

OPINION

Petitioner's claim for a credit under section 26 (c) (2), Revenue Act of 1936, based upon a contract requiring the pay-
31 ment of earnings and profits of the taxable year in discharge of a debt, has been disallowed by respondent. This action petitioner contests here. The principal ground relied upon by respondent as a justification for his position is that the contract did not require that the earnings and profits be paid or set aside within the taxable year. On this point petitioner must be sustained. The Strong Manufacturing Co., 41 B. T. A. — (May 29, 1940).

As to the taxable year 1937, respondent advances the further proposition that the contract pursuant to which petitioner made its payment was not entered into prior to May 1, 1936, as required by the statute. He bases this upon the fact that during that tax year the bonds with respect to which petitioner's payments were called for were being held only as collateral by the payee of a promissory note executed by petitioner subsequent to the critical date, the bonds having in the meantime been purchased by petitioner with funds supplied by the note creditor.

It seems clear that the bonds themselves were not extinguished by that transaction. *Virginia Securities Corporation* v. *Patrick Orchards, Inc., et al*, (C. C. A.—4), 20 Fed. (2d) 78, 84. The question remains whether petitioner's original undertaking to

contribute to the sinking fund established by the indenture under which the bonds were issued survived their transfer to the note holder as collateral. We think it did and that the obligation to maintain the sinking fund was effective so long as any bonds remained outstanding under the original indenture, even though held by a pledgee. *Bankers Trust Co.* v. *Denver Tramway Co.*, 233 N. Y. 604, 135 N. E. 936. That being so, the payments in question were called for by the original indenture which, having been entered into in 1932, was "executed by the corporation prior to May 1, 1936," as required by the applicable section. The credit should, therefore, have been allowed.

On the remaining issues no evidence has been presented, and the questions involved have been abandoned by petitioner, according to a statement in its brief. On these issues, respondent's determination is sustained.

Decision will be entered under Rule 50.

32 Before United States Board of Tax Appeals

Decision—No. 96406

(Entered July 16, 1940)

Pursuant to Memorandum Findings of Fact and Opinion of the Board entered on June 17, 1940, the respondent herein on July 11, 1940 having filed a recomputation of tax to which petitioner agrees, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax for the year 1936 in the amount of $1,449.88.

Enter:

[SEAL] (s) CLARENCE V. OPPER,
Member.

Before United States Board of Tax Appeals

Decision—No. 99552

(Entered July 16, 1940)

Pursuant to Memorandum Findings of Fact and Opinion of the Board entered on June 17, 1940, the respondent herein on July 11, 1940 having filed a recomputation of tax to which petitioner agrees, now, therefore, it is

Ordered and Decided: That there is a deficiency in income tax for the year 1937 in the amount of $1,117.23.

[SEAL] (s) CLARENCE V. OPPER,
Member.

33 In United States Circuit Court of Appeals

Petition for review and assignments of error—Nos. 96406 and 99552

Filed October 4, 1940

To the Honorable Judges of the United States Circuit Court of Appeals for the Sixth Circuit:

Now comes the Commissioner of Internal Revenue, by his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and John M. Morawski, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I. Jurisdiction

The petitioner on review is the duly appointed qualified and acting Commissioner of Internal Revenue, hereinafter referred to as the Commissioner, holding his office by virtue of the laws of the United States.

The respondent on review, Warren Tool Corporation (hereinafter referred to as the taxpayer), is a corporation organized and existing under the laws of the State of Ohio, with its principal office at Griswold Street Extension, Warren, Ohio. The Warren Tool Corporation filed its income and excess-profits tax returns for the calendar years 1936 and 1937 with the Collector of Internal Revenue for the 18th District of Ohio, at Cleveland, Ohio, and within the judicial circuit of the United States Circuit Court of Appeals for the Sixth Circuit.

The petitioner files this petition pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

II. Prior proceedings

On September 17, 1938, the Commissioner determined a deficiency in income tax for the taxable year ended December 31, 1936, in the amount of $3,037.25, and on June 27, 1939, determined a deficiency in income tax for the taxable year ended December 31, 1937, in the amount of $3,193.53, and sent to the taxpayer by registered mail notices of said deficiencies in accordance
34 with the provisions of existing internal revenue laws. The taxpayer filed petitions for redetermination of said deficiencies by the United States Board of Tax Appeals, December 12, 1938 and July 17, 1939, respectively.

The cases were consolidated and were tried before the Board of Tax Appeals on October 25, 1939, at Cleveland, Ohio.

On June 17, 1940, the Board entered its memorandum findings of fact and opinion, and on July 16, 1940, entered its decisions that there are deficiencies in income tax for the years 1936 and 1937 in the respective amounts of $1,449.88 and $1,117.23.

III. Nature of controversy

The issue decided against the Commissioner relates to the credit claimed by the taxpayer, under Section 26 (c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits.

Taxpayer on November 1, 1932, executed a first mortgage and deed of trust to the Cleveland Trust Company (hereinafter referred to as the trustee), securing bonds issued on that date in the amount of $50,000.00. Between November 1, 1932, and January 1, 1935, an additional $18,000.00 of bonds were issued, and on January 1, 1935, $68,000.00 of bonds were outstanding. The sinking fund provision in the first mortgage and deed of trust appears in Article IV thereof. It provided that for the purpose of creating the sinking fund for the redemption of bonds issued under the first mortgage and deed of trust, the taxpayer agrees to pay to the trustee on or before the 1st day of April, 1935, and on or before the 1st day of April of each year thereafter to and including April 1, 1942, a sum of money equal to 25 per centum of its net earnings for the calendar year next preceding. The taxpayer may, in lieu of depositing cash in whole or in part, purchase the issued bonds and deliver them to the trustee for credit against the sinking fund obligations. Prior to the first day of
35 April in each year, the taxpayer shall file with the trustee a sworn statement as to its earnings for the preceding calendar year.

In connection with the sinking fund requirement, taxpayer on March 23, 1936, delivered to the trustee $5,500.00 of its first mortgage bonds which it had purchased. On December 3, 1936, taxpayer delivered to the trustee, in consideration of the sinking fund requirements, $12,500.00 of its first mortgage bonds. On February 10, 1937, taxpayer certified to the trustee that its net earnings for 1936 were $44,068.90, and that the payment owed to the trustee was $11,017.22 which had been satisfied by the delivery of $12,500.00 of bonds in December, 1936.

By letter dated November 9, 1936, the taxpayer offered to borrow from The Second National Bank of Warren, (hereinafter referred to as the bank), the sum of $50,000.00 under the

terms and conditions set forth therein. The terms, which were agreed to by the bank, provided that upon acceptance the taxpayer will purchase all of its outstanding first mortgage bonds in the aggregate principal amount of $62,000.00; that it will tender to the trustee, for cancellation and discharge, $12,500.00 of such bonds; that it will execute on or before December 1, 1936, five promissory notes dated December 1, 1936, each in the principal amount of $10,000.00; that it will secure said notes by depositing with the bank $50,000.00 of its first mortgage bonds, $10,000.00 of such bonds to be redelivered to taxpayer for cancellation and discharge each time one of said notes is fully paid; and that taxpayer agrees upon request by the bank to enter into a supplemental agreement with the trustee, so that in case of default in payment of said notes it shall be considered an "event of default" under section 1, Article VI of the first mortgage and deed of trust. By letter dated December 1, 1936, from the taxpayer to the trustee and to the bank, and approved by the trustee and the bank, it was provided that in the event of default in payment of any of the notes in question, the bank was authorized to notify the trustee to declare the principal of the outstanding bonds to be forthwith due and payable and the trustee was
36 authorized to declare the principal of said bonds forthwith due and payable and to take any and all actions authorized under Article VI, "Remedies Upon Default", of the first mortgage and deed of trust.

On the receipt of this loan of $50,000.00 on or about December 3, 1936, taxpayer purchased $48,000.00 of its first mortgage bonds and delivered them to the bank to be held under the terms of the $50,000.00 loan. On or about December 3, 1936, taxpayer deposited $2,060.00 with the bank in connection with the purchase of the remaining $2,000.00 of bonds outstanding.

In December, 1937, taxpayer delivered to the trustee $14,000.00 of its first mortgage bonds. These bonds had been redelivered to taxpayer by the bank, upon taxpayer paying the bank the first $10,000.00 note due December 1, 1937, and $4,000.00 on the second $10,000.00 note due December 1, 1938. The net earnings of taxpayer for 1937 were determined by its accountant to be $52,214.10.

The Commissioner, in his notices of deficiency, refused to allow any credit claimed for contracts restricting dividend payments. The taxpayer claims credits of $11,017.22 for 1936 and $13,053.52 for 1937. The Board sustained the taxpayer on the authority of *The Strong Manufacturing Company* (1940), 41 B. T. A. — No. 174 (now pending on Commissioner's petition for review by Circuit Court of Appeals for the Sixth Circuit).

IV. Assignments of Error

The Commissioner avers that in the record and proceedings before the United States Board of Tax Appeals and in the opinion and final decisions rendered and entered by the United States Board of Tax Appeals, manifest error occurred and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceedings, opinion and final decisions so rendered and entered by the United States:

37 The Board erred:

1. In holding and deciding that there are deficiencies in income tax for the years 1936 and 1937 in the respective amounts of only $1,449.88 and $1,117.23.

2. In failing to sustain the deficiencies in income tax determined by the Commissioner for the years 1936 and 1937 in the respective amounts of $3,037.25 and $3,193.53.

3. In holding and deciding that taxpayer is entitled to the claimed credits of $11,017.22 and $13,053.52 for the years 1936 and 1937, respectively, under Section 26(c)(2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits.

4. In holding and deciding that the question is controlled by The Strong Manufacturing Company (41 B. T. A. — No. 174) decision.

5. In failing to hold that no part of the earnings of the taxpayer for either of the taxable years 1936 and 1937 was required by any provision of the contract to be paid or irrevocably set aside within the taxable year for the discharge of a debt, and hence taxpayer is not entitled to any credit under Section 26 (c) (2).

6. In holding that the original undertaking to contribute to the sinking fund establishing by the indenture under which the bonds were issued survived their transfer to the note holder as collateral, and that the obligation to maintain the sinking fund was effective so long as any bonds remained outstanding under the original indenture, even though held by a pledgee.

7. In that its opinion and decisions are not supported by the evidence and are contrary to law.

Wherefore, the Commissioner petitions that the decisions of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Sixth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the Clerk of said Court for

filing and that appropriate action be taken to the end that the errors complained of may be reviewed by said Court.

(Signed) SAMUEL O. CLARK, Jr.,
Assistant Attorney General,
(Signed) J. P. WENCHEL,
RLW
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
JOHN M. MORAWSKI,
Special Attorney, Bureau of Internal Revenue.

[*Duly sworn to by John W. Morawski; jurat omitted in printing.*]

In United States Circuit Court of Appeals

Notice of filing petition for review

Filed October 11, 1940

To: WARREN TOOL CORPORATION,
Grinwold Street Extension,
Warren, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 4th day of October, 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decisions of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 4th day of October, 1940.

(Signed) J. P. WENCHEL,
RLW
Chief Counsel,
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 8th day of October, 1940.

WARREN TOOL CORPORATION,
By (Signed) N. ANDERSON, *President,*
Respondent on Review.

40 In United States Circuit Court of Appeals

Statement of points

Filed November 22, 1940

Comes now the petitioner on review herein and makes this concise Statement of Points on which he intends to rely on the review herein, to-wit:

The United States Board of Tax Appeals erred:

1. In holding and deciding that there are deficiencies in income tax for the years 1936 and 1937 in the respective amounts of only $1,449.88 and $1,117.23.

2. In failing to sustain the deficiencies in income tax determined by the Commissioner for the years 1936 and 1937 in the respective amounts of $3,037.25 and $3,193.53.

3. In holding and deciding that taxpayer is entitled to the claimed credits of $11,017.22 and $13,053.52 for the years 1936 and 1937, respectively, under Section 26 (c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits.

4. In holding and deciding that the question is controlled by The Strong Manufacturing Company (41 B. T. A. — No. 174) decision.

5. In failing to hold that no part of the earnings of the taxpayer for either of the taxable years 1936 and 1937 was required by any provisoin of the contract to be paid or irrevocably set aside within the taxable year for the discharge of a debt, and hence taxpayer is not entitled to any credit under Section 26 (c) (2).

6. In holding that the original undertaking to contribute to the sinking fund established by the indenture under which the bonds were issued survived their transfer to the note holder as collateral, and that the obligation to maintain the sinking fund was effective so long as any bonds remained outstanding under the original indenture, even though held by a pledgee.

7. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

41 Service of a copy of the above statement of points is hereby acknowledged this 18th day of November, 1940.

(Signed) R. T. SAWYER, Jr.,
Counsel for Respondent on Review.

Before United States Board of Tax Appeals

Designation of portions of record, proceedings, and evidence to be contained in record on review

Filed November 22, 1940

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
   (a) Petitions
   (b) Answer to petitions.
3. Memorandum findings of fact and opinion, and decisions of the Board.
4. Petition for review.
5. Notice of filing petition for review.
6. Statement of points.
7. This designation.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

42 Service of a copy of the within designation of portions of record, proceedings, and evidence to be contained in records on review is hereby admitted this 18th day of November, 1940.

(Signed) R. T. SAWYER, Jr.,
Counsel for Respondent on Review.

[Clerk's certificate to foregoing transcript omitted in printing.]

43 Before United States Court of Tax Appeals

Order enlarging time

On motion of counsel for the petitioner, it is

Ordered: That the time for preparation and transmission of the record in the above entitled proceeding in the United States Circuit Court of Appeals for the Sixth Circuit, be and it is hereby extended to January 2, 1941.

[SEAL] (Signed) C. R. ARUNDELL,
Member.

Dated: Washington, D. C., November 4, 1940.

Now, November 30, 1940, the foregoing is certified from the record as a true copy.

(Signed) B. D. GAMBLE,
Clerk, U. S. Board of Tax Appeals.

44 In United States Circuit Court of Appeals for the Sixth Circuit

Cause Argued and Submitted

(November 11, 1941)

Before HAMILTON, MARTIN, and MCALLISTER, JJ.

This cause is argued by Bernard Chertcoff for Petitioner and by Paul W. Frum for Respondent and is submitted to the court.

In United States Circuit Court of Appeals

Decree

(Entered December 9, 1941)

This cause was heard upon the transcript of the record, briefs and arguments of counsel, and on consideration whereof,

It is ordered, adjudged, and decreed that the order of the Board of Tax Appeals be and the same is affirmed in accordance with our opinion in Commissioner of Internal Revenue vs. Strong Manufacturing Company, — Fed. (2d) —, this day decided.

45 [Clerk's certificate to foregoing transcript omitted in printing.]

46 Supreme Court of the United States

Order allowing certiorari

Filed April 6, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

File No. 46346. U. S. Circuit Court of Appeals, Sixth Circuit, Term No. 42. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. Warren Tool Corporation. Petition for a writ of certiorari and exhibit thereto. Filed March 5, 1942. Term No. 42, O. T. 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942



FILE COPY

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MAR 5 1942
CHARLES ELMORE CROPLEY
CLERK

No. ~~1016~~ 40

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE OHIO LEATHER COMPANY

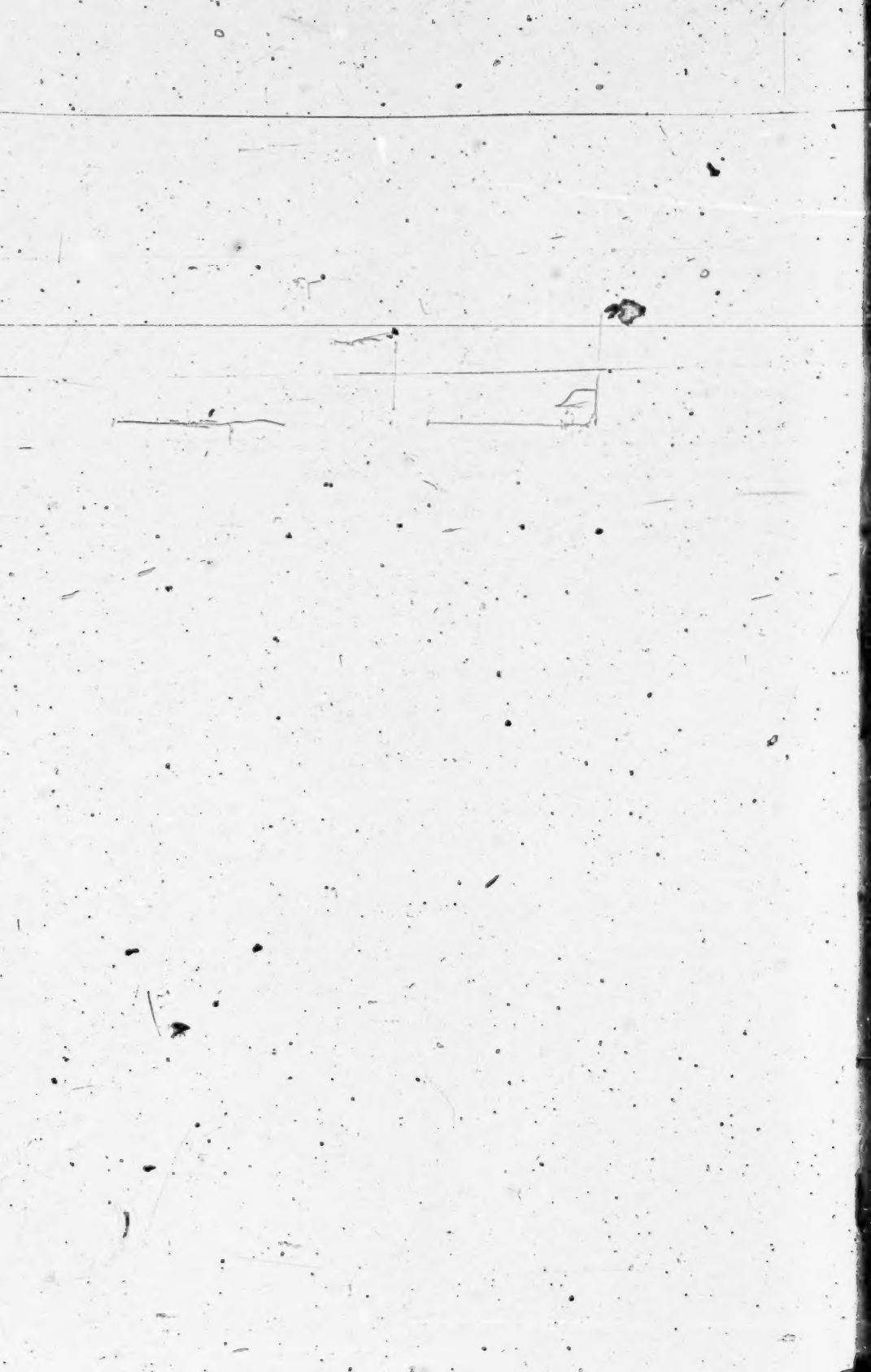
PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE OHIO LEATHER COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled case on December 9, 1941.

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 9–13) is not reported. The memorandum opinion of the Circuit Court of Appeals (R. 27) is reported in 124 F. (2d) 397.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 9, 1941. (R. 27.) The ju-

risdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to Section 26 (c) (2) of the Revenue Act of 1936, a credit against income subject to the undistributed profits tax is allowed to the extent that earnings are "required" by contract "to be irrevocably set aside within the taxable year" for the payment of debts. The question presented is whether the credit is allowable to the extent that a percentage of the net earnings of the taxable year was required to be set aside for sinking fund purposes on or before the first day of April of the following year.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*.

STATEMENT

As of January 1, 1936, the taxpayer corporation issued debentures in the amount of $900,000 to mature in ten years pursuant to a certain trust indenture. (R. 10, 11.) Under the terms of the indenture, the taxpayer was required, for sinking fund purposes, to pay to the trustee on January 1st of each year, beginning with the year 1937, the sum of $25,000, and in addition on or before the first day of April of each year, beginning with the year 1937, "an amount equal to ten percent (10%)

of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December." (R. 10.) And it was further provided that in lieu of payment of cash into the sinking fund, the corporation might deliver debentures to the trustee which had previously been issued and which the corporation had reacquired. (R. 11.)

During the year 1936, $81,000 of these debentures were purchased by the taxpayer at a cost of not less than the principal amount thereof, and on December 16, 1936, debentures having an aggregate face value of $47,000 were deposited with the sinking fund trustee, $25,000 of which were required under the bond indenture to be paid on or before January 1, 1937. The remaining $22,000 represented approximately 10 percent of the net earnings of the taxpayer for the calendar year 1936, which was required to be paid into the sinking fund "on or before the next succeeding first day of April." (R. 11–12.) The $22,000 deposit was made in 1936 rather than in 1937 in an effort to secure the benefits of Section 26 (c) (2) of the Revenue Act of 1936. (R. 12.) The taxpayer's net earnings, as defined by the trust indenture, for the calendar year ending December 31, 1936, were $209,493.62. (R. 13.)

The Commissioner of Internal Revenue refused to allow any credit claimed under Section 26 (c) (2) of the Revenue Act of 1936. The taxpayer

claimed a credit under that section of $20,949.36 being 10 percent of the net earnings for the year 1936. (R. 3, 4.) The Board of Tax Appeals held that the taxpayer was entitled to the credit claimed, and that the proposed deficiency was erroneous to the extent that such credit had not been allowed. A small uncontested deficiency was entered against the taxpayer. (R. 13.) The Circuit Court affirmed the decision of the Board. (R. 27.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the taxpayer corporation was entitled, under Section 26 (c) (2) of the Revenue Act of 1936, to a credit of $20,949.36 in the computation of its surtax on undistributed profits.

REASON FOR GRANTING THE WRIT

Since the indenture did not require that the earnings be set aside prior to April 1 of the succeeding year, it is plain that the taxpayer cannot meet the carefully worded condition of Section 26 (c) (2) that the contract must require the earnings "to be irrevocably set aside within the taxable year." In holding that the taxpayer was nevertheless entitled to the credit, the court below relied upon its opinion in a companion case, *Commissioner* v. *Strong Manufacturing Co.*, 124 F. (2d) 360, in which it recognized that its decision was contrary to *Antietam Hotel Corp.* v. *Commissioner*, 123 F. (2d) 274 (C. C. A. 4th). The deci-

sion herein is likewise in conflict with the *Antietam* case, in which a corporation was required for sinking fund purposes to pay to trustees on March 20 of each year 60 percent of its net earnings for the preceding calendar year. The Fourth Circuit denied the credit under Section 26 (c) (2) since the contract did not require the earnings to be irrevocably set aside within the taxable year. Cf. *Helvering* v. *Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8th), certiorari denied, November 10, 1941, Nos. 659–660, present Term, rehearing denied, January 12, 1942.

It is true that the earnings herein were in fact set aside during the taxable year whereas the earnings in the *Antietam* case were in fact set aside after the taxable year. But that fact is immaterial, since the critical condition of the statute is that the *contract must require* that the earnings be set aside during the taxable year, and on this issue the two decisions are in square conflict.

In view of the contrariety of views in the two circuits it is important to the orderly disposition of the numerous pending cases involving the undistributed profits tax that the issue be authoritatively adjudicated by this Court.

It is respectfully submitted that the petition should be granted.

CHARLES FAHY,
Solicitor General.

MARCH 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the

meaning of Section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds,

(2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1943

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No. ~~1017~~ 41

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE STRONG MANUFACTURING COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1941

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GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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THE STRONG MANUFACTURING COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled case on December 9, 1941.

OPINIONS BELOW

The majority and minority opinions of the United States Board of Tax Appeals (R. 19–22) are reported in 41 B. T. A. 1273. The opinion of the Circuit Court of Appeals (R. 134–141) is reported in 124 F. (2d) 360.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 9, 1941 (R. 134). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

A note and mortgage agreement required the taxpayer corporation to apply 40 percent of each calendar year's net earnings upon the unpaid balance of its obligation. This payment was to be made by the taxpayer not later than April 15th of the succeeding year. The question presented is whether the designated percentage of the earnings for 1936 was an amount "required * * * to be paid * * * or to be irrevocably set aside within the taxable year" 1936, as specified in Section 26 (c) (2) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix to the petition for a writ of certiorari in *Helvering* v. *The Ohio Leather Co.*, No. —, present Term, which is being filed together with this petition.

STATEMENT

In 1932, the taxpayer corporation became obligated upon a note in the amount of $50,000 which was secured by a mortgage (R. 14). The note was to be paid in eight annual installments of varying amounts, payments to commence April 15, 1934

(R. 15). In addition, the obligation provided that if 40 percent of the taxpayer's net earnings in any calendar year exceeded the prescribed annual payment then this excess was to be applied to the unpaid balance of the note (R. 16), but the payment of this additional sum was not required until April 15th of the succeeding year (R. 17).

On January 1, 1936, the taxpayer owed $47,000 on the principal amount of its indebtedness. During the year 1936, the taxpayer retired its obligation by payment of $46,500, the obligee waiving the balance of $500 and also waiving a small amount of interest. This sum of $46,500 was paid on the following dates and in the following amounts (R. 19):

2/15/36	$2,500	7/31/36	$1,000
4/15/36	2,500	8/14/36	500
5/15/36	500	8/31/36	2,000
5/29/36	1,000	9/15/36	500
6/15/36	500	10/15/36	34,000
6/29/36	1,000		
7/14/36	500	Total	46,500

By September 30, 1936, the taxpayer's approximate profits were $86,000. Since it appeared that taxpayer's profits would be such that 40 percent thereof would be in excess of the amount required to pay the note in full, it was decided to make the payment at that time (R. 19).

In computing the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, the taxpayer claimed a credit of $47,000 under Section 26 (c) (2). The Commissioner of Internal Revenue disallowed the credit (R. 6–8), but the

Board of Tax Appeals held that the taxpayer was entitled to a credit of $46,500 (R. 20). A small deficiency was entered against taxpayer upon uncontested issues (R. 23). The Circuit Court of Appeals affirmed the decision of the Board (R. 134).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the taxpayer corporation was entitled, under Section 26 (c) (2) of the Revenue Act of 1936, to a credit of $46,500 in the computation of its surtax on undistributed profits.

REASON FOR GRANTING THE WRIT

A writ of certiorari should issue for the reasons set forth in the Government's petition for certiorari filed herewith in *Helvering* v. *The Ohio Leather Co.*, No. —, decided by the court below on the authority of its decision in the instant case. The relevant provisions of the contracts in both cases are not identical but in view of the identity of the decisions it is clear that the present case did not turn upon any peculiar wording of the contract involved. The court below recognized (R. 140) that its decision was in conflict with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Antietum Hotel Corp.* v. *Commissioner*, 123 F. (2d) 274.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

MARCH 1942.

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No. —

In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WARREN TOOL COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WARREN TOOL COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit entered in the above-entitled case on December 9, 1941.

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 30–31) is not reported. The memorandum opinion of the Circuit Court of Appeals (R. 44) is reported in 124 F. (2d) 397.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 9, 1941 (R. 44). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

For sinking fund purposes the taxpayer corporation was by contract required to pay to a trustee on or before the first day of April of each year "a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding." The question presented is whether the designated percentage of earnings for the taxable calendar year was an amount "required * * * to be paid * * * or to be irrevocably set aside within the taxable year" as specified in Section 26 (c) (2) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix to the petition for a writ of certiorari in *Helvering* v. *The Ohio Leather Co.*, No. —, present Term, which is being filed together with this petition.

STATEMENT

On November 1, 1932, the taxpayer corporation executed a first mortgage and deed of trust securing bonds issued on that date in the amount of

$65,000. Between November 1, 1932, and January 1, 1935, an additional $18,000 of bonds were issued and on January 1, 1935, $68,000 of bonds were outstanding: (R. 24.) The mortgage contained a sinking fund provision which required the taxpayer on and after April 1935, to pay to the trustee "on or before the 1st day of April of each year * * * a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding." And provision was made for the deposit of bonds in lieu of cash (R. 25).

The taxpayer had no net earnings in 1934 so that no sinking fund payment was made in 1935. However, it had net earnings for the calendar year 1935 in the amount of $15,020.84 so that the required deposit was $3,755.21. The necessary payment was made on March 23, 1936, by the deposit of bonds in the amount of $5,500, which had theretofore been purchased by the taxpayer (R. 25).

In December 1936 the taxpayer's accountant estimated that its net earnings for the year 1936 would be about $50,000. It delivered to the trustee $12,500 of its first mortgage bonds for which it had paid $12,755. In February 1937 the taxpayer certified to the trustee that its net earnings for the calendar year 1936 were $44,068.90 and therefore the payment owed to the trustee was $11,017.22 which had already been satisfied (R. 26).

In December 1937, the taxpayer's accountant estimated that its net earnings for the year 1937

would be about $50,000. It delivered to the trustee $10,000 of its first mortgage bonds for which it had paid $10,000. Later in the month of December 1937, the taxpayer, upon reconsideration of the matter, estimated that its net earnings for the calendar year 1937 would be about $52,000, based on the accountant's revised report. It delivered to the trustee $4,000 more of its first mortgage bonds on December 28, 1937, for which it had paid $4,000. The net earnings of the taxpayer for the year 1937 were thereafter determined by its accountant to be $52,214.10, and therefore of the $14,000 of its first mortgage bonds deposited in December 1937, $13,053.52 were one-fourth of the net earnings (R. 30).

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the taxpayer claimed a credit under Section 26 (c) (2) of $11,017.22 for the year 1936, and $13,053.52 for the year 1937. The Commissioner of Internal Revenue determined that these credits should not be allowed and proposed to assess the resulting tax deficiencies (R. 5, 14). The Board of Tax Appeals held, however, that the taxpayer was entitled to the credits claimed, and that the proposed deficiencies were erroneous to the extent that such credits had not been allowed. Small deficiencies were entered against the taxpayer upon uncontested issues (R. 32). The Circuit Court affirmed the decision of the Board (R. 44).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the taxpayer corporation was entitled, under Section 26 (c) (2) of the Revenue Act of 1936, to credits of $11,017.22 and $13,053.52, in the computation of its surtax on undistributed profits for the years 1936 and 1937, respectively.

REASON FOR GRANTING THE WRIT

A writ of certiorari should issue in the instant case for the reasons set forth in the Government's petition for certiorari in *Helvering* v. *The Ohio Leather Co.*, No. —, a companion case involving the same issue and similarly decided by the court below.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

MARCH 1942.

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Nos. 40, 41, 42

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE OHIO LEATHER COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE STRONG MANUFACTURING COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WARREN TOOL CORPORATION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

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WARREN TOOL CORPORATION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

In the case of The Ohio Leather Company, No. 40, the opinion of the Board of Tax Appeals (Ohio,

R. 7–10)[1] is not reported, and the memorandum opinion of the Circuit Court of Appeals (Ohio, R. 19) is reported in 124 F. (2d) 397.

In the case of The Strong Manufacturing Company, No. 41, the majority and minority opinions of the Board of Tax Appeals (Strong, R. 14–16) are reported in 41 B. T. A. 1273, and the opinion of the Circuit Court of Appeals (Strong, R. 43–49) is reported in 124 F. (2d) 360.

In the case of Warren Tool Corporation, the opinion of the Board of Tax Appeals (Warren, R. 22–23) is not reported, and the memorandum opinion of the Circuit Court of Appeals (R. 31) is reported in 124 F. (2d) 397.

JURISDICTION

In each of these cases, the decree of the Circuit Court of Appeals was entered December 9, 1941 (Ohio, R. 19; Strong, R. 42; Warren, R. 31). The petitions for writs of certiorari were filed March 5, 1942, and were granted April 6, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In No. 40, the taxpayer was obligated under a bond indenture to pay to a trustee for each calendar year an amount equal to ten per centum of its net

[1] In this brief unless otherwise indicated we shall cite the record in No. 40 as Ohio; in No. 41 as Strong; and in No. 42 as Warren.

earnings for that year, but was not required to make the payment before April 1st of the succeeding year. For the year 1936, however, it in fact made the payment during 1936, and sought a credit therefor with respect to its undistributed profits tax for that year.

The question presented is whether the amount so paid was an amount "required * * * to be paid * * * or to be irrevocably set aside within the taxable year" within the meaning of Section 26 (c) (2) of the Revenue Act of 1936.[2]

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in Appendix A, *infra*, pp. 31–35.

STATEMENT[3]

1. *No. 40, Helvering* v. *The Ohio Leather Company*

As of January 1, 1936, The Ohio Leather Company issued debentures in the amount of $900,000

[2] The questions in Nos. 41 and 42 are substantially identical. In No. 42, the provisions of the contract required the payment of 25 per centum of the net earnings of the calendar year on or before April 1st of the succeeding year; and in No. 41, a note and mortgage agreement required the taxpayer to apply 40 per centum of each calendar year's net earnings upon the unpaid balance of its obligation, settlement for this amount to be not later than April 15 of the succeeding year. In both cases payment was in fact made during the calendar year.

[3] In the statements for these three cases, the record references contained in the parentheses are to the record for the particular case indicated by the subheading.

to mature in ten years pursuant to a certain trust indenture (R. 7, 8). Under the terms of this indenture, the corporation was required, for sinking fund purposes, to pay to the trustee on January 1st of each year, beginning with the year 1937, the sum of $25,000, and in addition on or before the first day of April of each year, beginning with the year 1937, "an amount equal to ten percent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December" (R. 7–8). It was also provided that in lieu of payment of cash into the sinking fund, the corporation might deliver to the trustee debentures which had previously been issued and which the corporation had reacquired (R. 8).

During the year 1936, $81,000 of these debentures were purchased by the taxpayer at a cost of not less than the principal amount thereof, and on December 16, 1936, debentures having an aggregate face value of $47,000 were deposited with the sinking fund trustee, $25,000 of which were required under the bond indenture to be paid on or before January 1, 1937. The remaining $22,000 represented approximately 10 per centum of the net earnings of the taxpayer for the calendar year 1936, which was required to be paid into the sinking fund "on or before the next succeeding first day of April" (R. 8). The $22,000 deposit was made in 1936 rather than in 1937 in order to obtain

the benefits of Section 26 (c) (2) of the Revenue Act of 1936 (R. 9). The corporation's net earnings, as defined by the trust indenture, for the calendar year ending December 31, 1936, were $209,493.62 (R. 9).

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the corporation claimed a credit under Section 26 (c) (2) of $20,949.36, 10 percent of the net earnings for the year 1936. The Commissioner of Internal Revenue disallowed the credit. (R. 2, 3.) The Board of Tax Appeals held that the corporation was entitled to the credit claimed, and that the proposed deficiency was erroneous to the extent that such credit had not been allowed. A small uncontested deficiency was entered against the corporation. (R. 10.) The Circuit Court affirmed the decision of the Board (R. 19).

2. *No. 41, Helvering* v. *The Strong Manufacturing Company*

In 1932, The Strong Manufacturing Company became obligated upon a note in the amount of $50,000 which was secured by a mortgage (R. 10–11). The note was to be paid in eight annual installments of varying amounts, payments to commence April 15, 1934 (R. 11). In addition, the obligation provided that 40 per centum of the corporation's net earnings in any calendar year was to be applied to the unpaid balance of the note

(R. 11, 12), but the payment of this additional sum was not required until April 15th of the succeeding year.[4]

On January 1, 1936, the corporation owed $47,000 on the principal amount of its indebtedness. During the year 1936, it retired its obligation by payment of $46,500, the obligee waiving the balance of $500 and also waiving a small amount of interest (R. 14). This sum of $46,500 was paid

[4] The pertinent provision (R. 12) reads as follows:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; * * *

"Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

In the court below, the Commissioner contended that the obligation was to pay only the amount of the earnings by which 40 per centum of such earnings exceeded the prescribed annual installment, and that since there was a duty to pay the installment of $5,000 for 1936 irrespective of the existence of earnings in that year, there was a separate reason for disallowing $5,000 of the credit claimed under Section 26 (c) (2). The court below held, however, that the $5,000 was in fact paid out of net earnings, and that therefore the taxpayer was also entitled to credit for that amount (R. 49).

on the following dates and in the following amounts (R. 14):

2/15/36	$2,500	7/31/36	$1,000
4/15/36	2,500	8/14/36	500
5/15/36	500	8/31/36	2,000
5/20/36	1,000	9/15/36	500
6/15/36	500	10/15/36	34,000
6/29/36	1,000		
7/14/36	500	Total	46,500

By September 30, 1936, the corporation's approximate profits were $86,000. Since it appeared that the profits would be such that 40 per centum would be in excess of the amount required to pay the note in full, the corporation decided to make the payment at that time (R. 14).

In computing the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, the taxpayer claimed a credit of $47,000 under Section 26 (c) (2). The Commissioner of Internal Revenue disallowed the credit (R. 6), but the Board of Tax Appeals held that the taxpayer was entitled to a credit of $46,500 (R. 14–15). A small deficiency was entered against taxpayer upon uncontested issues (R. 16–17). The Circuit Court of Appeals affirmed the decision of the Board (R. 42).

3. *No. 42, Helvering v. Warren Tool Corporation*

On November 1, 1932, the Warren Tool Corporation executed a first mortgage and deed of trust securing bonds issued on that date in the amount of $65,000. Between November 1, 1932, and January 1, 1935, additional bonds in the amount of $18,-

000 were issued and on January 1, 1935, $68,000 of bonds were outstanding (R. 17–18). The mortgage contained a sinking fund provision which required the taxpayer on and after April 1935, to pay to the trustee "on or before the 1st day of April of each year * * * a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding." Provision was made for the deposit of bonds in lieu of cash (R. 18).

The corporation had no net earnings in 1934 and, accordingly, no sinking fund payment was made in 1935. For the calendar year 1935, its net earnings were $15,020.84 so that the required deposit was $3,755.21. Payment was made on March 23, 1936, by the deposit of bonds in the amount of $5,500, which had been purchased by the corporation (R. 18).

In December 1936, the corporation's accountant estimated that its net earnings for the year 1936 would be about $50,000. At that time, therefore, it delivered to the trustee $12,500 of its first mortgage bonds for which it had paid $12,755. In February 1937, the corporation notified the trustee that its net earnings for the calendar year 1936 were $44,068.90 and that the payment owed to the trustee was $11,017.22 which had already been satisfied by the December payment (R. 18–19).

In December 1937, the corporation's accountant estimated that its net earnings for the year 1937

would be about $50,000. It delivered to the trustee $10,000 of its first mortgage bonds for which it had paid $10,000. Later in the same month, the corporation, upon reconsideration, estimated that its net earnings for the calendar year 1937 would be about $52,000, based on the accountant's revised report. On December 28, 1937, it delivered to the trustee an additional $4,000 of its first mortgage bonds for which it had paid $4,000. The accountant thereafter determined that the net earnings of the corporation for the year 1937 were $52,214.10, and that, therefore, the sum of $13,053.52 constituted the amount due under the agreement; this amount had been paid by the deposit of first mortgage bonds in the amount of $14,000 in December 1937 (R. 21, 22).

In computing the surtax on undistributed profits imposed by the Revenue Act of 1936, the corporation claimed a credit under Section 26 (c) (2) of $11,017.22 for the year 1936, and $13,053.52 for the year 1937. The Commissioner of Internal Revenue determined that these credits should not be allowed and proposed to assess the resulting tax deficiencies (R. 3, 7). The Board of Tax Appeals held, however that the taxpayer was entitled to the credits claimed, and that the proposed deficiencies were erroneous to the extent that such credits had not been allowed. Small deficiencies were entered against the taxpayer upon uncontested issues (R. 23). The Circuit Court affirmed the decision of the Board (R. 31).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in each of these cases in holding that the taxpayer corporations were entitled to credits under Section 26 (c) (2) of the Revenue Act of 1936 in the computation of their surtax on undistributed profits.[5]

SUMMARY OF ARGUMENT

Section 26 (c) (2) of the Revenue Act of 1936 provides, *inter alia*, that a corporation shall be entitled to a credit with respect to its undistributed profits tax if it has entered into a contract which requires that a portion of its net earnings and profits either be paid within the taxable year in discharge of a debt or be irrevocably set aside within the taxable year in discharge of a debt. Since the section grants a credit in the nature of a deduction, it must be strictly construed and taxpayers must carry the burden of showing compliance with its terms. There was no such showing here. In each of these cases, although taxpayers were obligated to pay a portion of their net earnings of the taxable year, their contracts did not require payment until several months after the close of such year; tax-

[5] In the case of The Ohio Leather Company, the court below erred in holding that the corporation was entitled to a credit of $20,949.36; in the case of The Strong Manufacturing Company, it erred in holding that the corporation was entitled to a credit of $16,500; and in the case of Warren Tool Corporation, it erred in holding that the corporation was entitled to a credit of $11,017.22 for the year 1936 and of $13,053.52 for the year 1937.

payers were not therefore *required* to make payment within the taxable year. Nor did the contracts require that taxpayers irrevocably set aside the specified percentage of their net earnings within the taxable year in which their earnings arose. The contracts made no provision for setting aside. The only contractual requirement was that taxpayers make payment after the close of the taxable year; until the specified date of payment they were free to use the net earnings as they saw fit.

The legislative history of the tax on undistributed profits confirms the conclusion that taxpayers were not entitled to a credit. That history establishes an intent rigidly to circumscribe the conditions under which a credit is available. Throughout consideration of the bill, Congress insisted upon limiting credits to a sharply defined minimum. It expressly refused to afford broad credits in the case of allocation of earnings to the payment of debts. In addition, the legislative history establishes that Congress expressly insisted upon providing credits only where the required conditions occurred *within the taxable year*. The House Bill originally provided for credits in case of payments of dividends during the "dividend year." The term "dividend year" covered the period of March 15 of the taxable year to March 14 of the following year, and its purpose was to afford a taxpayer corporation time to cast up its accounts and determine the distribution of its net

income. Nevertheless the term "taxable year" was subsequently substituted for "dividend year." Although the problem of computation of earnings during the taxable year so as to allow payment within that year was repeatedly called to the attention of Congress, Congress insisted upon retention of the requirement that payment must be made within the taxable year.

ARGUMENT

TAXPAYERS WERE NOT ENTITLED TO CREDITS SINCE THE AGREEMENTS DID NOT CONTAIN ANY PROVISION REQUIRING EARNINGS OF THE TAXABLE YEAR TO BE PAID OR IRREVOCABLY SET ASIDE WITHIN THAT YEAR

In each of these cases the taxpayer corporation contracted to apply a percentage of its net earnings of a particular calendar year to an indebtedness of the corporation; in each case the agreement expressly provided only that the payment of the specified percentage was to be made on or before an appointed date—April 1 in the case of The Ohio Leather Company and Warren Tool Corporation, and April 15 in the case of The Strong Manufacturing Company—in the year following the calendar year during which the net earnings arose. By virtue of these contracts, taxpayers have sought to avail themselves of the credits authorized by Section 26 (c) (2) of the Revenue Act of 1936 (Appendix A, *infra*, pp. 32–33), which relieves from the tax on undistributed profits any profits which may not be distributed because of a contract

requiring that a portion of earnings of the taxable year be paid or irrevocably set aside *within* the taxable year for the discharge of a debt. Since this section grants a credit in the nature of a deduction, permitted only in sharply circumscribed circumstances, it must be strictly construed, and taxpayer must carry the burden of showing compliance with its precise terms. *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46; cf. *White* v. *United States,* 305 U. S. 281, 291. We submit the taxpayers here have failed so to comply, and that they were not, therefore, entitled to the credit provided.

1. Section 26 (c) (2) expressly and rigidly limits the conditions under which a corporation which devotes its earnings or profits to the payment of debts rather than to the payment of dividends is entitled to relief from the tax on undistributed profits. As specific conditions precedent to the credit, (1) there must be a written contract executed by the corporation prior to May 1, 1936; (2) this contract must contain a provision expressly dealing with the disposition of earnings and profits of the taxable year; and (3) the contract must also contain a provision requiring that a portion of such earnings and profits either (a) be paid within the taxable year in discharge of a debt or (b) be irrevocably set aside within the taxable year in discharge of a debt. A taxpayer whose contract satisfies each of these three requirements is entitled to a credit to the extent of the amount which has

been so paid or irrevocably set aside.[6] Thus it will be seen that a sharp and exact line is drawn to separate corporations eligible for the credit from those ineligible; even though a corporation on one side of the line may be in a position no different for business purposes from a corporation on the other side, the one may be entitled to the credit and the other not.[7] The situation under Section 26 (c) (2) is thus like that under Section 26 (c) (1), where the effective prohibition against the payment of dividends does not entitle the taxpayer to a credit unless it is the precise type of prohibition required by Section 26 (c) (1). *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46.

Taxpayers in these cases have met the first of the two statutory requirements except as noted in the margin:[8] The written contracts antedated May 1,

[6] Section 26 (c) (2) is complementary to Section 26 (c) (1) (*infra*, Appendix A), which provides for a credit in the case of certain contracts which expressly prohibit the payment of dividends. It will be noted that the credit provided in Section 26 (c) (1) is not dependent upon the existence of a debt, while the credit allowed by Section 26 (c) (2) does not turn upon a contractual provision dealing with dividends. In the case of a contract which forbids the payment of dividends in order that a debt be discharged and which requires that there be payment or an irrevocable setting aside within the taxable year of earnings of the taxable year, the corporation is entitled only to the largest of the credits and cannot take credits under both subsections. See Section 26 (c) (1).

[7] For example, the agreement of a corporation may have been dated May 2, or, although executed before May 1, may be oral. Although the corporation may be just as effectively bound to pay debts out of earnings as a corporation with a

1936, and their provisions expressly dealt with the disposition and earnings of the taxable year. The third requirement, however, has not been met. In the case of the indenture of The Ohio Leather Company, the payment of ten per centum of the 1936 earnings to the trustee for sinking fund purposes was not required until April 1, 1937. In the case of the mortgage of Warren Tool Corporation, the payment of 25 per centum of the 1936 earnings, and the same percentage of the 1937 earnings, was not required until April 1, 1937, and April 1, 1938, respectively. The mortgage of The Strong Manufacturing Company similarly provided that the Company was to apply 40 per centum of the net earnings for 1936 in payment of the debt, but settlement was required to be made only by April 15, 1937.

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written agreement executed before May 1, the latter is entitled to a credit, the former is not.

* As to $5,000 paid in 1936, The Strong Manufacturing Company did not meet the second requirement, viz., that the contract must contain a provision which "expressly deals with the disposition of earnings and profits * * *"

The Strong Manufacturing Company contends that the contract required it to pay the installment of $5,000 in 1936 out of 40 per centum of the profits of 1936 to the extent that such percentage is sufficient to cover any or all of the sum of $5,000. But it seems clear that even under this interpretation of the agreement, which is contrary to the Commissioner's interpretation (see *supra*, p. 6, note 4), the corporation is not entitled to a credit for the $5,000 since in the words of the agreement itself, the corporation was "absolutely required" (R. 12) to pay $5,000 on April 15, 1936, *even in the event that there were no earnings.* A contract which re-

It is clear, therefore, that the express provisions relating to the time of payment of each of these agreements do not satisfy one condition of Section 26 (c) (2): The agreements required no payment until three months or more after the close of the taxable year, while the credit under Section 26 (c) (2) is available only if the payment must be made within the taxable year.

The court below, however, in its opinion in the Strong case (Strong, R. 43–49) held that a contract which requires a percentage of net earnings for a specified year to be paid on a certain date in the succeeding year nevertheless fulfills the conditions of the Act since such a contract requires an irrevocable setting aside in the taxable year within the meaning of Section 26 (c) (2). Its conclusion was based not upon any fact peculiar to any one of the contracts*; it was, rather, apparently based upon the broad proposition that any contract by which a corporation agrees that it shall pay a percentage of earnings of the taxable year, is, without more, a contract irrevocably to set aside such portion within

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quires a payment irrespective of earnings and profits cannot be said to deal expressly with the disposition of earnings and profits. See Article 26-2 (c) of Treasury Regulations 94, Appendix A, *infra*, p. 34. Since the $5,000 payment made on April 15, 1936, was made pursuant to a contractual requirement which had no express connection with earnings and profits, a separate reason exists for disallowing $5,000 of the $46,500 credit allowed The Strong Manufacturing Company.

* In its argument in the court below, The Strong Manufacturing Company urged that its agreement to "apply" 40 per centum of its net earnings, "settlement" to be by April

the taxable year, regardless of the date specified for payment.[10] But plainly no such conclusion is warranted either expressly or by implication. In contrast to their provisions relating to payment, each of the contracts is wholly silent in respect of any setting aside. The contracts do not in terms require the taxpayers to set aside the amount due, nor

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15 of the succeeding year, constituted an agreement irrevocably to set aside the 40 per centum in the taxable year. Although the court below adverted to this contention (Strong, R. 45), its holding could not have turned on the particular wording of the Strong agreement since it decided the other two cases, not involving similar language, upon the basis of the Strong opinion.

[10] Thus the court below stated (Strong, R. 45): "To sustain the respondent [Strong Manufacturing Co.], we are required * * * to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain, or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax."

The court then held that Section 26 (c) (2) is to be construed so to provide. But the basis of its premise that the contracts required an irrevocable setting aside as so defined does not appear and it assumed, as stated in the text, that the bare agreement to pay a percentage of earnings for the taxable year satisfied the requirements. This assumption may have been based on the court's view that, as a practical matter in the normal operation of a business, an obligation to make a payment in 1937 would require a setting aside in 1936. Even if this were true, no "irrevocable setting aside"

do they require any segregation or physical retention at all. The only requirement was that the taxpayers pay on or before a date *after* the close of the taxable year. Up to that date of payment, there was no actual fund segregated and identifiable as "net earnings," which presumably consisted only of bookkeeping entries showing that current assets exceeded current liabilities for the year. As far as the agreements were concerned, therefore, until the date set for payment taxpayers were entirely free to use this "excess," along with other assets, for the purchase of new equipment, for investment, or for other appropriate purposes; if they were under any obligation whatever up to the date set for payment, it was only one, imposed by operation of law, to refrain from such a dissipation or distribution of the specified percentage of net earnings, which would put the percentage beyond the reach of the trustees or creditors. It is true that taxpayers did in fact "irrevocably set aside" within the taxable year the specified percentages by paying those percentages, but they chose the time of payment voluntarily and not pursuant to the requirements of their contract. Accordingly, since not compelled by an express provision of the contract,

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would be involved. And in any event, it would not be a setting aside "required by a provision of a written contract" as provided by Section 26 (c) (2). The section plainly provides that the setting aside within the taxable year must be required "by the terms of a written contract * * *." Regulations 94, Article 26 (c) (2), Appendix A, *infra*, p. 34. See *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 51–52.

the irrevocable setting aside did not satisfy the requirement of Section 26 (c) (2). *Antietam Hotel Corp.* v. *Commissioner*, 123 F. (2d) 274 (C. C. A. 4); *Helvering* v. *Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8).

The holding of the court below to the contrary—that the statutory condition that the contract require an irrevocable setting aside is satisfied by a contract which provides for payment of net earnings of the taxable year on a date in a subsequent year—renders meaningless the provision of Section 26 (c) (2) relating to payment within the taxable year. Plainly if it be held that any written contract executed before May 1, 1936, and requiring payment of net earnings of the taxable year automatically becomes a contract irrevocably to set aside such percentage, no matter how remote the date of payment, the words "to be paid within the taxable year" become wholly superfluous. For, under the construction suggested by the court below, the date for payment specified by the contract would be immaterial for all purposes, since, according to its view, the mere requirement of payment out of earnings of a given year entails a requirement that there be an irrevocable setting aside within that year. Such a construction does violence to the plain terms of Section 26 (c) (2).

2. The taxpayers, however, have urged, and the court below agreed (Strong, R. 46–48) that Congress could not have intended to withhold the credit provided by Section 26 (c) (2) from corporations

which have contracted to pay a percentage of net earnings of the taxable year on a date in the succeeding year. If, it is said, the credit were not allowed in cases such as these, the credit is illusory since few corporations are able to compute their net earnings of a taxable year until the succeeding year.[11] Accordingly, it has been urged, Congress must have intended that a credit be allowed here and the terms of Section 26 (c) (2) must be reformed to permit the credit.

We submit that the requirements of Section 26 (c) (2) are so plain and unambiguous that there is no occasion for resort to legislative history. But even were the text of the section less clear, its legislative history would not warrant the granting of a credit in the situations here presented. For that history establishes an intent to circumscribe rigidly and to define sharply the conditions under which a credit is due, and shows also an awareness that the credit was to be withheld in cases such as this.[12]

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[11] See Strong, R. 46; brief of The Strong Manufacturing Company in the court below, pp. 11–16, 20–33, 42–43.

[12] It may be noted that, in any event, the credit is not as completely unavailable as a practical matter as has been suggested. While we may assume that normally a corporation cannot precisely determine and pay a percentage of its net earnings until the year succeeding the taxable year, it could have contracted to pay during the taxable year upon the basis of quarterly statements, such as were submitted by The Strong Manufacturing Company to the trustee (Strong, R. 32); in addition, it is demonstrably plain that it was practicable to pay within the taxable year upon an approximation of net earnings—a course which each of the taxpayers followed here. See statement of Congressman Samuel B. Hill, 80 Cong. Rec. 10265.

The entire legislative course of the undistributed profits tax demonstrates that Congress intended severely to limit credits for a corporation's payment of debts and precisely to define the situation in which taxpayers were to be entitled to the credit. The Revenue Act of 1936 was introduced in the House of Representatives as H. R. 12395 (80 Cong. Rec. 5978); it proposed to eliminate entirely the normal existing taxes on corporate income and substitute a tax at rates graduated from zero to 42½ per centum upon undistributed net income (Section 13, Appendix B, *infra*, p. 36). Such undistributed net income was to be determined by deducting from net income the amount of dividends paid during the "dividend year" (Sections 13 and 27, Appendix B, *infra*, pp. 36, 39–40). In addition, credits were provided in certain situations where the corporation had deficits or debts: A corporation with a deficit at the beginning of the taxable year was to pay only a flat tax rate of 22½ per centum upon that portion of the undistributed earnings of the taxable year necessary to make up the deficit, and a tax at graduated rates upon the balance of the undistributed earnings of the taxable year (Section 14, Appendix B, *infra*, pp. 36–37); further, if the debts of the corporation exceeded accumulated earnings at the beginning of the taxable year, that portion of the earnings of the taxable year specified by the corporation for the yearly amortization of the excess during the next five years or more was taxed at the flat rates and the remainder at gradu-

ated rates (Section 16, Appendix B, *infra* pp. 38–39)."

Thus it will be seen that from the outset, credits in the case of debts or deficits were specifically limited, and even where the conditions were fulfilled, the tax at the flat rate was to be imposed upon the earnings which were applied to cover debts or deficits. And although the opponents of the bill in the House of Representatives attacked these provisions as affording insufficient relief in the case of debts, its sponsors insisted that the "cushions" were sufficient. See 80 Cong. Rec. 6004, 6212–6213, 6228, 6304.

The Senate Committee on Finance altered the form of the House Bill in major respects. The Senate Bill restored the existing general corporate income tax and substituted for the House graduated tax on profits not distributed through dividend payments a flat seven percent tax upon such undistributed profits. See S. Rep. No. 2156, 74th Cong., 2d Sess. (1936), pp. 5, 12. The Senate Bill omitted altogether credits for corporations with debts or deficits; instead it provided in Section 26 (c) only for a credit where a corporation had executed a written contract prior to March 3, 1936,

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" Section 15 (Appendix B, *infra* pp. [illegible]) also permitted a credit if the payment of dividends out of earnings during the "dividend" year was restricted by contract; such restricted earnings of the taxable year were to be taxed at the flat rate and the earnings free for dividend distribution, but not distributed, were to be taxed at the graduated rates.

which prohibited the corporation from paying dividends during the taxable year." This elimination of even the restricted credits provided in the House Bill was explained on the ground that the moderate rate of seven per centum made "the complicated relief provisions" unnecessary. S. Rep. No. 2156, 74th Cong., 2d Sess. (1936), p. 12.

As in the House, opponents of the bill, both at the hearings and in the course of debate, sharply criticized the failure to afford credits in the case of payment of debts. See 80 Cong. Rec., 9045, 10164, 10467. But the supporters of the view embodied in the bill were unconcerned with the problem of debts: They insisted that the moderate rate provided by the Senate made the credit unneces-

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[14] The present Section 26 (c) (2) was adopted without discussion or debate as an amendment proposed on the floor of the Senate toward the close of the consideration of the Bill; it was accompanied only by a statement of Senator Couzens (80 Cong. Rec. 9071) that it had been—

"generally discussed in the committee; and in view of the language of the bill there were left out, in the judgment of the committee, other forms of debts than those dealing with the payment of dividends. The last words on line 22, page 53 [the proposed Section 26 (c) (1) which afforded a credit in the case of a contract which prohibited payment of dividends "during the taxable year"] seem to exclude obligations of the corporation to pay debts or withhold earnings for specific purposes under contract.

"I have consulted those on the committee, and so far as the committee is concerned, there seems to be no reason for not adopting the amendment."

It is plain, therefore, that Section 26 (c) (2) was intended only to parallel and complement Section 26 (c) (1).

sary [15]; that fully to provide for credits for debt payments would make the raising of sufficient revenue impossible and would create large loopholes by which corporations could escape the tax [16]; and that there was no reason to discriminate between individuals, who received no credit for the payment of debts, and corporations.[17] And in fact an amendment introduced by Senator Adams to broaden the credit for payment of debts by providing a credit for all portions of adjusted net income "expended or applied during the taxable year for the liquidation, payment, or reduction of the principal of any bona-fide indebtedness outstanding at the date of the enactment of this Act" was rejected. 80 Cong. Rec., 9055, 9070.

It is plain, therefore, that Congress did not intend general relief in the case of corporate earnings utilized for the payment of debts; on the contrary, the sponsors and supporters of the bill which ultimately became the Revenue Act of 1936.

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[15] 80 Cong. Rec. 8649 (Senator King), 10467 (Senator Barkley).

[16] 80 Cong. Rec. 9056–9057, 9058, 10467 (Senator Barkley), 9070 (Senator Couzens).

[17] 80 Cong. Rec., 9056, 10467 (Senator Barkley), 10471 (Senator LaFollette); compare p. 10474 (Senator Connally). Supporters of the House Bill advanced the same analogy. See 80 Cong. Rec. 6228 (Mr. Buck). And it was further urged that the hardship of paying the tax on income which went for the payment of debts could be avoided by payment of taxable stock dividends, and utilization of the earnings for the payment of debts. See 80 Cong. Rec. 9045 (Senator LaFollette).

expressly opposed such relief." But the legislative history of the Revenue Act of 1936 not only establishes this general intent to keep credits to a sharply defined minimum; it shows also that relief was not intended to be afforded unless the required conditions occurred *within the taxable year.*

Thus, the problem of computing earnings before the close of the taxable year was expressly considered. As first introduced in the House of Representatives, the bill provided that undistributed net income was to be determined by deducting from net income the amount of dividends paid during the "dividend year." Where the taxable year coincided with the calendar year, the term "dividend year" covered the period of March 15 of the taxable year to March 14 of the following year. Sections 13 and 27, Appendix B, *infra,* pp. 36, 39–40. And this same provision was applied to the credit in the case of contracts prohibiting payment of dividends: The corporation was entitled to a credit if the con-

[16] For this reason, the suggestion advanced by taxpayers and the court below (see Strong, R. 46, 47) that the tax was intended to be imposed only upon corporate income which was not distributed at all must be rejected. For the entire course of the bill makes clear that the tax was intended to be imposed primarily upon income not distributed in the form of dividends; that it may have been "distributed" for other purposes, such as plant improvement and expansion, acquisition of new equipment, replacement of lost or destroyed equipment, or payment of debts was immaterial for purposes of credits.

tract prohibited the payment of dividends during the "dividend year." Section 15, Appendix B, *infra*, pp. 37–38. In explaining the purpose of the term "dividend year," Congressman Samuel B. Hill, chairman of the subcommittee of the House Ways and Means Committee, stated (80 Cong. Rec. 6005):

> It takes the corporation some time to cast up its accounts and determine just how much its net income is and how much it wants to distribute and how much it wants to withhold. If you make the dividend year coincide with the taxable year, they would have to have this all figured out before the end of the taxable year.

Nevertheless, Congressman Hill subsequently offered, and the House adopted, a committee amendment substituting the "taxable year" for the "dividend year." Congress thus plainly insisted that payments be made within the taxable year for entitlement to the credit. 80 Cong. Rec. 6308. And in subsequently adopting Section 26 (c) (2), it clearly was aware of the strict limitations which its inclusion in that section of the clause "within the taxable year" entailed.

Just as the taxpayers here and in the court below have urged the practical difficulties of computing earnings within the taxable year so as to qualify for the credit by making payment in that year, so were such difficulties urged before the Senate and the House of Representatives. Witnesses before the Senate Committee on Finance insisted that the

House bill was too restricted since it failed to provide for a period after the taxable year during which earnings could be computed and payments, qualifying the taxpayer for credits, could be made. Hearings before the Senate Committee on Finance on H. R. 12395 (74th Cong., 2d Sess.), pp. 385, 417–418. Yet the term "taxable year" was retained and the Senate added no amendment to satisfy the objections which had thus been called to its attention. And further, the present Section 26 (c) (2) using the term "within the taxable year" was, in fact, introduced as a Senate committee amendment (see *supra*, p. 23, note 14), after the hearings at which these objections had been made. The inference is plain that the section, therefore, was intended to provide a credit only in the case of a contract which explicitly required a payment or an irrevocable setting aside before the close of the taxable year in which the earnings had arisen. Similarly, after the bill had gone to conference and been reported out, the issue of difficulty of computation of earnings during the taxable year was again raised in the House of Representatives, and the following colloquy occurred (8 Cong. Rec. 10265):

> Mr. RICH. * * * If a corporation does not know what its earnings are going to be in 1936, is it going to be compelled to pay the surtax on all of its earnings, provided it does not pay the earnings to the stockholders in the year 1936?

Mr. SAMUEL B. HILL. That is correct. If it does not pay it out in 1936, it will pay a surtax on the undistributed portion.

Mr. RICH. There is not a corporation in the United States that earns over $100,000 that knows within 30 to 60 days after the end of the year what its earnings are going to be.

Mr. SAMUEL B. HILL. They will certainly know approximately what their earnings are.

Finally, that the credit provisions were intended by Congress to be carefully limited is made clear by the history of the Revenue Act of 1938, c. 289, 52 Stat. 447. The limited scope of Section 26 (c) had been the source of wide complaint, and accordingly, the 1938 Act retained a tax on undistributed profits only in a restricted sense (see Section 13) and included broader provisions for credits in connection with payment of indebtedness." But one of the

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" The Act provided:

"SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

"(a) *Definition in General.*—As used in this title with respect to any taxable year the term "dividends paid credit" means the sum of:

* * * * *

"(4) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind, if such amounts are reasonable with respect to the size and terms of such indebtedness. As used in this paragraph the term "indebtedness" means only an indebtedness of the corporation existing at the close of business on December 31, 1937, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of

very reasons which led to these amendments in 1938 was stated by the House Committee on Ways and Means (H. Rep. No. 1860, 75th Cong., 3d Sess.) (1939–1 Cum. Bull. (Part 2) 728, 730) to be:

> The relief provisions applying to corporations having contracts not to pay dividends or requiring the use of current earnings for the payment of debts are so restrictive as to provide relief only in rare cases, although many other cases equally meritorious receive no relief.

It is against this background that Section 26 (c) (2) of the Revenue Act must be considered. Congress plainly was aware of, and insistent upon, its rigid limitation of credits for debt payments; it expressly refused to make provision for post-tax year computations and payments; and it was not until 1938 that it broadened its provisions, at the same time that it confirmed the limited scope of the earlier Act. In these circumstances, even were the words of Section 26 (c) (2) less unambiguous, its legislative history would preclude the granting of a credit in the situations presented by these cases.

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trust, issued by the corporation and in existence at the close of business on December 31, 1937, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date. * * *"

The credit, accordingly, was made available without reference to the particular terms or requirements of the indebtedness.

CONCLUSION

The judgment of the court below should be reversed in each of these cases.

Respectfully submitted.

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SEPTEMBER 1942.

APPENDIX A

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

(1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a re-

quirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*— For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26–2. *Credit in connection with contracts restricting payment of dividends.*— (a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the

discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the

taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *

APPENDIX B

Excerpts from H. R. 12395, 74th Congress, 2d Session, as introduced into House of Representatives:

SEC. 13. TAX ON CORPORATIONS.

(a) DEFINITIONS.—As used in this title—

(1) The term "adjusted net income" means the net income in excess of the credit provided in section 26 (relating to interest on certain obligations of the United States and Government corporations);

(2) The term "undistributed net income" means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27; and

(B) The tax computed under subsection (b).

(b) RATE OF TAX IN GENERAL.—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

* * * * *

SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

(a) GENERAL RULE.—If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being

computed under section 13, be computed by adding:

(1) A tax of 22½ per centum of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) TAX NOT TO BE INCREASED.—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

SEC. 15. CONTRACTS NOT TO PAY DIVIDENDS.

(a) GENERAL RULE.—If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the dividend year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the dividend year from being paid as dividends during the dividend year; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) TAX NOT TO BE INCREASED.—This section shall not be applied in any case in which such application would operate to increase

the tax which would be payable without its application.

SEC. 16. DEBTS.

(a) DEFINITION OF "DEBT."—As used in this section the term "debt" means an indebtedness of the corporation existing at the close of business on March 3, 1936, and evidenced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence at the close of business on March 3, 1936, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date; to the following extent:

(1) If having a maturity at the time of issue of three years or more, then to the full amount thereof;

(2) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to represent indebtedness incurred by the corporation prior to March 4, 1933; or

(3) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to evidence indebtedness of the corporation incurred in the acquisition of capital assets, except (A) shares of stock in any corporation, or (B) rights to subscribe for or to receive such shares, or (C) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation, with interest coupons or in registered form, or (D) certificates of profit, or of interest in property or accumulations, in any investment trust or similar organization holding or dealing in any of

the instruments mentioned or described in this paragraph, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act.

(b) COMPUTATION OF TAX.—If the sum of all the debts computed under subsection a) of this section is in excess of the accumulated earnings and profits of the corporation as of the day before the first day of its first taxable year beginning after December 31, 1935, and if the corporation, in its return for its first taxable year under this title, specifies the number of consecutive taxable years (not less than five) over which such debt excess shall be amortized for the purposes of this subsection, then for such number of consecutive taxable years, beginning with the first taxable year of the corporation under this title (or if no such specification is made, then for the first ten taxable years) the tax imposed by section 13, in lieu of being computed under such section, shall be computed by adding:

(1) A tax of 22½ per centum of an amount of the adjusted net income equal to the amount of such debt excess divided by the number of years so specified (or, if no specification, then by ten); and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) DEFINITION OF "DIVIDEND YEAR."—The term "dividend year", when used in this title with reference to a corporation,

means the period beginning on the fifteenth day of the third month after the day before the beginning of the taxable year (whether the taxable year is a period of twelve months or a shorter period) and ending on the fourteenth day of the third month after the close of the taxable year.

(b) DIVIDEND CREDIT IN GENERAL.—For the purposes of this title, the dividend credit shall be the amount of dividends paid during the dividend year corresponding to the taxable year.

* * * * *

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Nos. 40, 41, 42

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE OHIO LEATHER COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE STRONG MANUFACTURING COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WARREN TOOL CORPORATION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITIONER'S SUPPLEMENTAL MEMORANDUM

In the Supreme Court of the United States

OCTOBER TERM, 1942

Nos. 40, 41, 42

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE OHIO LEATHER COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE STRONG MANUFACTURING COMPANY

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

WARREN TOOL CORPORATION

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITIONER'S SUPPLEMENTAL MEMORANDUM

At the oral argument petitioner was requested to file a memorandum stating petitioner's position

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with respect to the application of section 43 of the Revenue Act of 1936 to the problem presented here.

The contention is made at pages 18–21 of the Brief for Respondent in No. 40, *Helvering* v. *Ohio Leather Company*, and at page 21 of the Brief for Respondent in No. 42, *Helvering* v. *Warren Tool Corporation*, that because these taxpayers were on the accrual basis of accounting they were, by virtue of section 43, entitled to the credit contained in section 26 (c) (2). This contention is without merit, because principles of accrual accounting have no bearing on the question of whether or not a contract requires a payment or an irrevocable setting aside within the taxable year.

The question here is not whether the taxpayers made payment within the taxable year. They did in fact do so though their contracts did not require it. However, if this were the question section 43 and the principles of accrual accounting might have some application, since a taxpayer on the accrual basis is permitted to treat payments required but not made, or receivable but not received, as having been actually made or received.

Here, however, the sole dispute is whether certain contracts required the taxpayers to pay or set aside irrevocably within the taxable year. The principles of accrual accounting do not affect the meaning of contractual provisions; the effect of

accrual principles is to regard as having been paid that which contracts require to be paid, and accrual principles cannot be applied until the meaning and effect of contractual requirements are ascertained. As the question here is what the taxpayers' contracts required, the question here is one which must be decided in advance of any possible application of accrual principles.

Possibly the effect of the taxpayers' contracts was to cause them to accrue the annual payments as an obligation of the taxable year. The statute, however, allows no credit where a contract merely requires an accrual for or within the taxable year. The contract must require a portion of the earnings or profits of the taxable year "to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt," and no serious suggestion can be made that an accrual is an irrevocable setting aside or a payment.

The taxpayers' contention that section 43 has pertinence is based on the fact that section 43 states specifically that it is to be disregarded in computing the credit provided by section 27 and makes no such statement regarding section 26. The logic of this argument is fully met if any provision of section 26 exists to which accrual principles can be applied. Subdivisions (a) and (b) of section 26 respectively provide credits for "The amount received as interest upon obligations of the United States" and for "85 per centum of

the amount received as dividends." In the determination of credits under these two provisions accrual principles can properly be given effect, so the logic of taxpayers' argument seems to compel a recognition that Congress intended section 43 to be given effect in computing such credits. It does not, however, mean that Congress thought that accrual principles could be applied in determining the effect of every requirement in each subdivision of section 26. Thus, some of the requirements which must be met before a credit under section 26 (c) (2) can be allowed are that a contract exist which be (a) written, and (b) entered into before May 1, 1936. Of course section 43 cannot have pertinence in a consideration of these requirements. Neither can it in a consideration of the year in which such a contract requires payments to be made or irrevocably set aside.

CONCLUSION

The taxpayers' contention that section 43 is pertinent in this case is erroneous. As the other contentions made by the taxpayers are erroneous for the reasons stated in petitioner's brief and at the oral argument, the judgments below should be reversed.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

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In the Supreme Court of the United States

OCTOBER TERM 1941.

Supreme Court, U. S.
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No. ~~1016~~. 40

GUY T. HELVERING,
Commissioner of Internal Revenue,
Petitioner,

vs.

THE OHIO LEATHER COMPANY,
Respondent.

No. ~~1018~~. 42

GUY T. HELVERING,
Commissioner of Internal Revenue,
Petitioner,

vs.

WARREN TOOL CORPORATION,
Respondent.

JOINT BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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In the Supreme Court of the United States

OCTOBER TERM 1941.

No. 1016.

GUY T. HELVERING,
Commissioner of Internal Revenue,
Petitioner,

vs.

THE OHIO LEATHER COMPANY,
Respondent.

No. 1018.

GUY T. HELVERING,
Commissioner of Internal Revenue,
Petitioner,

vs.

WARREN TOOL CORPORATION,
Respondent.

JOINT BRIEF IN OPPOSITION TO PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

PRELIMINARY STATEMENT.

This is a joint brief submitted by the respondents in *Helvering, Commissioner v. The Ohio Leather Company,* No. 1016, and *Helvering, Commissioner v. Warren Tool Corporation,* No. 1018, in opposition to the Commissioner's petitions for writs of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit to review its judgments (R. Leather 27; R. Tool 44)[1] entered in the

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[1] Record in *Ohio Leather Co.* case is designated: "(R. Leather ....)"; record in *Warren Tool Co.* case is designated "(R. Tool ....)."

two cases on December 9, 1941. The issues in these two cases are similar enough to warrant the filing of a joint brief[2] at this stage of the proceedings. Other than a common interest in the questions here involved, these two corporations, their officers and shareholders, are complete strangers to each other. The Ohio Leather Company and the Warren Tool Corporation (mistakenly designated sometimes by the Petitioner as Warren Tool Company) reserve the right to present their separate arguments in separate briefs and on oral hearing in event this Court should grant the writs.

OPINIONS BELOW.

Neither of the opinions of the United States Board of Tax Appeals (R. Leather 9-13; R. Tool 24-31) are officially reported. The memorandum opinions of the Sixth Circuit Court of Appeals (R. Leather 27; R. Tool 44) are reported in 124 F. (2d) 397.

JURISDICTION.

The judgments of the Circuit Court of Appeals were entered on December 9, 1941 (R. Leather 27; R. Tool 44). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED IN THE CASES.

The tax involved is imposed by Section 14(b) of the Revenue Act of 1936 on the corporations' "undistributed net income" which is defined in Section 14(a)(2) as "the adjusted net income minus the sum of the dividends paid credit provided in Section 27 and the credit provided in Section 26(c), relating to contracts restricting dividends."

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[2] The Petitioner, for his reason for granting the writ in the *Warren Tool* case merely refers to his argument in the application in the *Ohio Leather* case.

The controversy is over the allowance of credits under Section 26(c)(2) (set out in full in the Appendix) of sinking fund payments required under trust indentures. The Commissioner contends that the taxpayers are not entitled to the credits because the percentages of the net earnings were not payable until the year following the taxable years. The taxpayers contend that they are entitled to the credits because they were required by the terms of their respective indentures to irrevocably set aside within the taxable years such respective amounts, and that upon consideration of their estimated net earnings toward the end of each taxable year they did so irrevocably set aside—by actually paying to their respective trustees the amounts claimed as deductions.

STATUTES AND REGULATIONS INVOLVED.

The statutes and regulations involved are set out in the Appendix *infra*.

STATEMENT.

Each of the taxpayers is an Ohio corporation and each, prior to the critical date, May 1, 1936, issued obligations pursuant to trust indentures. Under the terms of each indenture each taxpayer was required to make sinking fund payments.

Thus, it was provided in Article Two of the Ohio Leather Company indenture that:

> "Section 1. The Company covenants that, to create a Sinking Fund for the further security of the Debentures issued hereunder, it will pay to the Trustee • • • on or before the next succeeding first day of April, • • • an amount equal to ten per cent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December, as such net earnings are defined hereinafter in this Article, which sums and amounts shall be held by the Trustee for the security of all

outstanding Debentures until paid out as hereinafter provided. * * *

"Section 2. On or before April 1, 1937, and thereafter annually on or before April 1st in each year to and including April 1, 1945, the Company will cause Ernst & Ernst of Cleveland, Ohio, or such other certified public accountant or accountants as may be approved by the Trustee hereunder, to determine the amount, if any, of the net earnings of the Company for the fiscal year ended the last preceding December 31st.

* * * * * *

"Section 5. * * *

"In lieu of payment of cash into the Sinking Fund as above provided in Section 1 of this Article, the Company may deliver to the Trustee, to apply upon such payments, Debentures issued hereunder with all unmatured coupons attached thereto, which have previously thereto been issued, sold and repurchased by the Company or otherwise acquired by the Company, and in each such event shall have credit therefor to the extent of the principal amount of such Debentures (but without accrued interest or premium thereupon) so delivered to the Trustee. The fact of re-purchase or re-acquisition by the Company shall be disclosed to the Trustee by a certificate with respect thereto delivered by the Company to the Trustee at the time of the delivery of said Debentures. The Company may, but need not, anticipate payments to the Sinking Fund either in cash or in Debentures and have credit therefor on its thereafter accruing obligation or obligations to pay moneys or deposit Debentures for the Sinking Fund." (R. Leather 10-11.)

And in the Warren Tool indenture in Article Four it was similarly provided that:

"Section 1. For the purpose of creating the sinking fund for the redemption of the bonds issued hereunder, the Company hereby agrees to pay to the Trustee on or before the 1st day of April, 1935, and on or before the 1st day of April of each year thereafter to and including April 1, 1942, a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for

the calendar year next preceding. * * * The Company may, in lieu of depositing cash in whole or in part, purchase bonds issued hereunder at a price not exceeding the redemption price thereof as fixed by the provisions of Article V hereof, and deliver such bonds to the Trustee for credit against said sinking fund obligations to the extent of the purchase price (excluding the accrued interest) paid therefor by the Company. * * * Prior to the first day of April in each year abovementioned, the Company shall also file with such Trustee a statement sworn to by one of such officers showing the amount of the Company's net earnings for the preceding calendar year computed in the manner hereinbefore provided and duly certified by such accountant or accountants." (R. Tool 25; as corrected for typographical error by typewritten stipulation filed in C. C. A. 6, March 7, 1941.)

The credits claimed are credits for payments made (by the deposit of bonds) within the taxable years towards the end of each year after computations of the respective taxpayer's apparent profits had been made. Both the taxable years 1936 and 1937 are involved in the Warren Tool case. Only the taxable year 1936 is involved in the Ohio Leather case. The actual credits claimed and allowed by both the Board of Tax Appeals and the Circuit Court of Appeals are the percentages of the net earnings as finally determined. Thus, for example, in the Ohio Leather Company case the taxpayer, on December 14, 1936, estimated that its net earnings for that taxable year would be about $220,000.00 (R. Leather 24) and accordingly deposited $22,000.00 in bonds on this obligation. As a matter of fact, the actual earnings turned out to be $209,493.62 (R. Leather 25), and accordingly the actual credit claimed is only $20,949.36, being 10% of the net earnings for the taxable year. Similarly, Warren Tool Corporation made, in December of 1936 and also in December of 1937, such payments in amounts determined in like manner.

ARGUMENT.

REASONS FOR DENYING THE WRITS.

A. There is no real conflict between the decision in the Strong Mfg. Co. case, the decision below and the decidecision of the Fourth Circuit in the Antietam Hotel case. The difference is one of facts.

There is here involved no question of importance[1] in Federal tax law. The statute is no longer in force. The Sixth Circuit Court of Appeals, in applying the statute, followed settled rules of construction. The Commissioner does not contend otherwise, but does suggest that a conflict exists between the decisions of the Sixth Circuit in these cases (and also its decision in *Commissioner v. Strong Mfg. Co.*; 124 F. (2d) 360, certiorari applied for; No. 1017, this being the case on which the Circuit Court based its decisions in the *Ohio Leather* and *Warren Tool* cases) and the decision of the Fourth Circuit Court of Appeals in *Antietam Hotel Corp. v. Commissioner*, 123 F. (2d) 274. We think this suggestion of conflict is error. The petitioner's statement in its Reason For Granting the Writ that:

> "* * * the court below relied upon its opinion in a companion case, *Commissioner v. Strong Manufacturing Co.*, 124 F. (2d) 360, in which it recognized that its decision was contrary to *Antietam Hotel Corp. v. Commissioner*, 123 F. (2d) 274 (C. C. A. 4th). The decision herein is likewise in conflict with the *Antietam* case, in which a corporation was required for sinking

[1] In his brief oppo ng the granting of the Writ of Certiorari in *Moloney Electric Co. v. Commissioner*, Nos. 659-660, certiorari denied November 10, 1941, rehearing denied January 12, 1942, the Commissioner said:

> "Contrary to petitioner's assertion (Pet. 6), the cases do not present any important issue of Federal law which this Court should determine. They merely involve claims to credits in the computation of the surtax imposed by the Revenue Act of 1936 upon undistributed corporate profits, and their outcome turns not on any new or far-reaching principle of law, but on the particular facts."

> fund purposes to pay to trustees on March 20 of each year 60 percent of its net earnings for the preceding calendar year. The Fourth Circuit denied the credit under Section 26 (c) (2) since the contract did not require the earnings to be irrevocably set aside within the taxable year. Cf. *Helvering v. Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8th), certiorari denied, November 10, 1941, Nos. 659-660, present Term, rehearing denied, January 12, 1942." (Commissioner's Pet. Ohio Leather, pp. 4, 5.)

refers to the following from the opinion of the Sixth Circuit Court of Appeals in the *Strong* case:

> "We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp. v. Commissioner of Internal Revenue*, 4 Cir., 123 F. 2d 274, it was held 'that as an indispensable condition precedent to the allowance of the credit, the contract itself must in terms require that a portion of the earnings and profits of the taxable year be * * * irrevocably set aside within the taxable year.' We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, in terms. With regard to the case of *Helvering v. Moloney Electric Co.*, 8 Cir., 120 F. 2d 617, in which it was held that the taxpayer was not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless." (124 F. 2d 360, 365-6.)

The *Antietam* decision of course contained the language quoted in the above excerpt from the Court's opinion in the *Strong* case, indicating that the Fourth Circuit, *if it had had to pass* on that question, would have for that

reason denied the credit. That the taxpayer in the *Antietam* case was in fact in no position to obtain the credit under the principles of the *Strong* case is shown by difference in the facts, a situation recognized by the Board of Tax Appeals* for, in denying the credit in the *Antietam* case, it first pointed out that the funds were never segregated during the taxable years but remained in the general bank account. *The credit by the statute is limited "to the extent that such amount has been so paid or set aside."* The Board in the *Antietam* case said:

> "We have considered the general question involved in the instant proceeding in two recent opinions. In *Strong Mfg. Co.*, 41 B. T. A. 1273 (Dec. 11,122), wherein the taxpayer was granted a credit, it appears that the company anticipated its income for the taxable year and actually did make the payments within the taxable year there in question. *Therein the facts differ materially from our instant case.*
>
> In June of 1940 this Board decided the case of *Moloney Electric Co.*, 42 B. T. A. 78 (Dec. 11,214), which considered a similar question. In this later case we found against the taxpayer. We said that in the *Strong* case the creditors had an equitable lien throughout the entire taxable year recognized by the taxpayer, whereas in the *Moloney* case the creditor had no equitable lien upon the taxpayer's earnings unless and until they should be in excess of $320,000. While there was a payment of certain moneys within the taxable year by the taxpayer in the *Moloney* case, we said:
>
> > The record does not disclose whether the payment was made near the close of the year when it was apparent that the earnings would be in excess of $320,000, or whether it was made earlier in the year when the earnings were much less than that amount.
>
> In our instant case [i.e., the *Antietam* case], although the petitioner insists that the bondholders had

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*In its memorandum opinion entered October 23, 1940 and reported *C. C. H. Board of Tax Appeals Service*, Dec. 11,357-A.

an equitable lien, the contract expressly provides that they were entitled to nothing provided the net profits, calculated according to the indenture, did not exceed $10,000. Consequently, we have a situation analogous to that of the *Moloney* case with the exception that in our present case nothing was physically transferred within the taxable year. Our lien, if such it be, is closely comparable to the lien of that case. There the Board, although recognizing that a lien may have existed at some time, nevertheless, denied the taxpayer a credit. We must here follow the holding of the *Moloney* case. * * * Furthermore, a stronger factor is here present which was not discussed in the *Moloney* case. There was no actual payment here within the taxable year, nor any visible setting aside of funds. Therefore, it can not be said that all of the requirements of the statute have been fulfilled.

For the above reasons we must hold in favor of the respondent.

Decision will be entered under Rule 50." *C. C. H. Board of Tax Appeals Service*, Dec. 11,357-A, p. 33,150.

Further evidence that there was no "issue" (as Petitioner claims, Pet. Ohio Leather, 5) in the *Antietam* case as to whether or not a contract *must in express terms* require the earnings be set aside with the taxable year, is found in the opinion of the Fourth Circuit in quoting the facts found by the Board of Tax Appeals:

"The corporation [Antietam Hotel] made no entry on its books between January and March of 1937 or 1938 relative to the sinking fund payments. The balance sheet of the petitioner for the year ended December 31, 1936 carried a notation thereon as follows:

'Sinking Fund payment due March 20, 1937, $4,642.09.' and for the year ended December 31, 1937:

'Sinking Fund payment due March 20, 1938, $13,527.32.'

The percentage of net earnings of petitioner as defined in Section 3 of the Supplemental Indenture, *supra, was held in the general bank account* of the cor-

poration until March of the years following. (123 F. 2d 274, 275-6.)

• • •

Since the organization of the petitioner, James Mullen of Richmond, Virginia, has been associated with it either as assistant secretary or acting as secretary and its counsel; and during the years 1936 and 1937 he attended the Board meetings and advised the executive committee. He *advised them* that the money must be set aside as of December 31st of each year and must be held separate and not used for any purpose other than the payment to the trustee. He *advised them* that it constituted a trust fund which they could not use and that they themselves would become personally liable if they permitted it to be used." (Emphasis ours.) (123 F. 2d 274, 276.)

Then in its opinion the court said:

"Petitioner contends very strenuously that the applicable law of Maryland treats this indenture as an express trust, and that, accordingly, the funds covered by the indenture cannot be diverted from the ultimate use set out in the indenture without the violation of a duty under the trust. Consequently, petitioner claims that there was in this case an irrevocable setting aside of the funds by operation of law. *It is clear from the record, however, that these funds were never actually segregated* from the taxpayer's other moneys during the taxable years in question. Indeed, the evidence discloses that during the taxable years in question, *the funds actually remained in petitioner's general bank account, and it is quite clear that actual payments to the Trustee were not made during the taxable years* but were, in each instance, paid by check during March of the year after the taxable year. Thus, *there was no definitive act within the taxable year which divested the corporation's control over the funds.*". (Emphasis ours.) (123 F. 2d 274, 276.)

After the Court quoted Regulations 94, Art. 26(c)(2) set out in full in the appendix, the Court said:

"Thus, it will be noted that the Treasury Regulation restricts the credit to amounts *actually* set aside

within the taxable year. Although such an interpretation is not binding on this Court, it is highly persuasive at least." (Emphasis the Court's.) (123 F. 2d 274, 277.)

In view of the foregoing, we respectfully insist that there is no conflict between the *Strong* case and the *Antietam* case for the issue decided in the *Strong* case was never present in the *Antietam* case, since in the *Antietam* case there had been no actual setting aside within the taxable year as required by the statute and it therefore was no concern of the Fourth Circuit whether or not the statute makes it mandatory that the contract require *in terms* the setting aside within the taxable year.

The expression of the Court in the *Strong* case that it did not reach the "same conclusion" as the Fourth Circuit in the *Antietam* case was accordingly dictum since the Fourth Circuit under the facts had no need in its disposition of the case to reach "a conclusion" on this point. Likewise, the member of the Board of Tax Appeals in *A. E. Staley Manufacturing Company v. Commissioner*, 46 B. T. A. .... (No. 26) January 27, 1942, when he said that the opinions of the two circuits are "apparently in conflict * * * on the question as to whether, under Section 26(c)(2), the contractual provision must *in terms* require that a portion of the earnings and profits of the taxable year be irrevocably set aside or paid within the taxable year," was guilty of either dictum or insufficient analysis of the two cases. In the *Staley* case the taxpayer had made its "anticipatory payment" by delivering in cash, in December of the taxable year, an amount equal to the required percentage of the estimated net earnings. The contract (trust indenture) in this case specifically forbade such a procedure by its exact terms, for it provided:

> "* * * no anticipated sinking fund payment may be made in cash:" (p. 2 of the advance sheet of the *Staley* decision.)

On the basis of this provision, the Board of Tax Appeals in the *Staley* case held that even under the decision in the *Strong* case the credit should be denied to the taxpayer in the *Staley* case, and in so doing, in effect, reached the same conclusion that Respondents herein contend is controlling, *viz*: that each case turns on its own facts.

B. The judgments below were correct.

The Commissioner has refrained from filing a brief in support of his petition—relying on the asserted conflict. We believe we have shown above that this "conflict" is not within the following principle which this Court has told the bar it strives to maintain, *viz.*:

> "* * * that it is very important that we be consistent in not granting the writ of certiorari except in cases involving principles the settlement of which is of importance to the public as distinguished from that of the parties, and in cases where there is a real and embarrassing conflict of opinion and authority between the circuit courts of appeal." Taft, *C.J.* (*Layne & Bowler Corporation v. Western Well Works, Inc., et al.*, 261 U. S. 385, at p. 393.)

These cases are not of public importance. The tax was so drastically changed by Sections 13 and 27(a)(4) of the Revenue Act of 1938 (since it was so unsatisfactory in operation) that a decision in these cases would afford little or no aid in any cases under subsequent acts. (*Mertens Law of Federal Income Taxation, 1939 Supplement*, § 32B.02, page 1499.

Since the Commissioner has not indicated in what respect, if any, the decision of the Sixth Circuit Court of Appeals in *Commissioner v. Strong Manufacturing Company*, 124 F. (2d) 360, on which that court based its judgments in the *Ohio Leather* and the *Warren Tool* cases, was in error, the taxpayers here will refrain from a lengthy discussion of the opinion below. After stating the facts as found by the Board of Tax Appeals, the court in the *Strong*

case said that the critical question was whether or not the construction claimed for the statute by the Commissioner, namely, that "to set aside" required a physical separation or appropriation, was correct. It pointed out that such a construction would forbid credits to any corporation whose business was such that it could not definitely ascertain its profits on the last day of the year and thus deny the credit to all manufacturing and merchandising companies and grant it only to financial institutions.* It relied on the fundamental principle of statutory construction that the intention of the legislature is the most important guide and to ascertain that intention it will be presumed that unfair, undue hardship was not intended. Further guides for ascertaining the intention of the legislature used by the court were the principles that substance and not form controls in taxing statutes and that the title and the legislative scheme or plan, which was the object of the act, may be examined. The court termed, rightly we believe, the contention of the Commissioner as one that would result in an "unreasonable, capricious, and discriminatory plan of taxation," 124 F. (2d) 360, 365, which should be held to be contrary to the Congressional intention.

Finally in applying the statute with the foregoing principles, both the Board of Tax Appeals and the Sixth Circuit Court of Appeals held that under the facts (i.e. both the terms of the trust indentures and the specific payments) each of the taxpayers met the requirements for credits under Section 26(c)(2) of the Revenue Act of 1936. We believe that additional authorities or arguments of our own to further demonstrate the correctness of the court's judgments would be here inappropriate since the Commissioner has not filed a brief; however, we do desire to note that the Commissioner in the entire course of the con-

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* Financial institutions were exempt from this tax. Section 107 of the Revenue Act of 1936; c. 690, Title I, Section 104, 49 Stat. 1677.

troversies has never shown how Section 26(c)(2) should be construed to give relief to any corporation which was required to pay or set aside a percentage or portion* of its year's earnings and profits to a sinking fund. Any such construction would, we submit, inevitably include these taxpayers.

CONCLUSION.

For the reasons shown above, we respectfully submit that there is not a conflict of opinion and authority between the Circuit Courts of Appeals or error in the result reached by the Sixth Circuit Court of Appeals in its judgments in these cases or a question of great public importance and accordingly the petitions for the writs of certiorari should be denied.

Respectfully submitted,

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* As shown *supra*, Congress included in Section 26(c)(2) the provision: "* * * a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. * * *" This provision and the phrase "irrevocably set aside within the taxable year for the discharge of a debt" also in the statute, unmistakably manifest the intention of Congress to meet situations where the payment was postponed so that the payment or setting aside would include a portion or percentage of the profits of an entire year. As already stated by this Court this surtax on undistributed profits is one "* * * imposed on profits earned during a definite period—a tax year—* * *" *Helvering v. Northwest Steel Mills*, 311 U. S. 46, 53 (1940). It is equally manifest, we believe, that should a corporation after the accumulation of earnings and profits dissipate these earnings and profits before the final date for an accounting under the trust indenture, it, the corporation, would breach its contract and the trustee, if it knowingly acquiesced in such conduct, would be guilty of [illegible]

APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with

the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * * *

(c) *Disposition of profits of ~~taxable~~ year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion

of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * * *

Supreme Court, U. S.
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CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. 40.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE OHIO LEATHER COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

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In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. 40.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

THE OHIO LEATHER COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

I. OPINIONS BELOW.

Neither the memorandum opinion of the United States Board of Tax Appeals, entered June 13, 1940 (R. 7-10), nor the decision of the Board entered under Rule 50 on July 3, 1940 (R. 16), are reported. The memorandum opinion of the Circuit Court of Appeals for the Sixth Circuit, entered December 9, 1941 (R. 19), is reported in 124 F. (2d) 397 (1941).

II. JURISDICTION.

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

III. STATEMENT OF THE CASE.

A. The Proceedings Below.

This is a proceeding by the Commissioner of Internal Revenue (hereinafter referred to as the "Commissioner") to review a judgment of the United States Circuit Court of Appeals for the Sixth Circuit affirming an order of the United States Board of Tax Appeals overruling the Commissioner's determination disallowing a claimed credit of $20,949.36 against adjusted net income in computing the surtax upon undistributed profits of respondent, The Ohio Leather Company, (hereinafter referred to as the "taxpayer"), for the year 1936. An order allowing certiorari was entered by this Court April 6, 1942. (R. 20.)

The Board of Tax Appeals decided the case upon the authority of *Strong Manufacturing Company*, 41 B. T. A. 1273 (1940) and the United States Circuit Court of Appeals for the Sixth Circuit affirmed the Board of Tax Appeals in accordance with that Court's opinion in *Helvering, Commissioner v. Strong Manufacturing Company*, 124 F. (2d) 360 (1941).[1]

B. Question Presented.

There is no factual dispute between the parties herein. The tax involved was imposed by Section 14 (b) of the Revenue Act of 1936 upon "undistributed net income" which is defined in Section 14 (a) (2) as "the adjusted net income minus the sum of the dividends paid credit provided in Section 27 and the credit provided in Section 26 (c), relating to contracts restricting dividends." The issue presented calls for the application of a correct interpretation of the law to the provisions of a written contract relating to the disposition of profits of the taxable

[1] This case (No. 41) and that of Helvering, Commissioner v. Warren Tool Corporation (No. 42), involving substantially the same question as the case at bar are being heard by this Court in consecutive order.

year in discharge of a debt within the purview of Section 26 (c) (2) of that Act. The specific question presented is whether the taxpayer is entitled to a credit under the aforesaid Section upon its 1936 Federal Income Tax Return.

The Commissioner concedes the existence of a written contract executed by the taxpayer prior to May 1, 1936, and that it contains a provision expressly dealing with the disposition of earnings and profits of the taxable year to be applied in discharge of a debt. (Brief p. 14.) He challenges only the third requirement of Section 26 (c) (2) and contends that the taxpayer is not entitled to the credit because the contract does not contain any provision requiring that earnings of the taxable year be paid or irrevocably set aside within that year.

The taxpayer contends that it is entitled to the claimed credit because:

(1) The fixing within the contract of April 1 of the succeeding year for the delivery of the sums to discharge this liability was consistent with the provisions of Section 26 (c) (2) of the Act—a final determination of the amount due being physically impossible of ascertainment until after the close of the taxable year;

(2) The contract required it to irrevocably set aside within the taxable year a percentage of its earnings and profits[1] *for* the discharge of a debt which had accrued within the taxable year; and

(3) Upon consideration of its estimated net earnings within the taxable year and from the income of such year it irrevocably set aside *by actual payment* the amount now claimed as a credit.

---

[1] The Indenture uses the phrase "net earnings" (R. 7, 17) but under Treasury Regulations 94, promulgated under the Revenue Act of 1936, Art. 26-2 (c) (Appendix) such is considered the equivalent of "earnings and profits." The Commissioner does not contend otherwise.

C. Statutes and Regulations Involved.

The statutes and regulations involved will be found in the Appendix, *infra*.

D. Statement of Facts.

Substantially all of the facts have been stipulated (R. 16-18); certain facts appearing in the following statement and not a part of the stipulation have been found by the Board of Tax Appeals from the record. (R. 7-10.)[1]

As of January 1, 1936, the taxpayer corporation issued sinking fund debentures in the principal amount of $900,000.00 to mature in ten years pursuant to the terms of a certain Trust Indenture. (R. 8.) The sinking fund provision in the Indenture is in part as follows:

> "Section 1. The Company covenants that, to create a Sinking Fund for the further security of the Debentures issued hereunder, it will pay to the Trustee * * * on or before the next succeeding first day of April, * * * an amount equal to ten per cent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December, as such net earnings are defined hereinafter in this Article, which sums and amounts shall be held by the Trustee for the security of all outstanding Debentures until paid out as hereinafter provided. * * *
>
> "Section 2. On or before April 1, 1937, and thereafter annually on or before April 1st in each year to and including April 1, 1945, the Company will cause Ernst & Ernst of Cleveland, Ohio, or such other certified public accountant or accountants as may be approved by the Trustee hereunder, to determine the amount, if any, of the net earnings of the Company for the fiscal year ended the last preceding December 31st." (R. 7-8.)

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[1] All references hereinafter contained in this Statement of Facts are to the Memorandum Opinion of the Board of Tax Appeals found on pp. 7-10 of the Record unless otherwise indicated.

It was also provided that in lieu of the payment of cash into the sinking fund, the taxpayer could deliver to the trustee debentures which had previously been issued and subsequently reacquired by the taxpayer. (R. 8.)

Prior to December 14, 1936, the taxpayer estimated that ten per cent (10%) of its net earnings under the above quoted section of the Indenture for the taxable year 1936 would amount to $22,000, and at a meeting of its Board of Directors held December 14, 1936, the following resolution was unanimously adopted:

> "Whereas, the Indenture covering the Company's issue of Nine Hundred Thousand Dollars ($900,000) Ten Year 5% Convertible Sinking Fund Debentures, due January 1, 1946, dated January 1, 1936, makes mandatory the disposition of net earnings, and
>
> "Whereas, Section 26 (c) 2 of the Revenue Act of 1936 (defining credits permitted in connection with contracts restricting payments of dividends) required the payment or irrevocable setting aside within the taxable year, of the specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936; and
>
> "Whereas, information has been furnished to this Board of Directors that the ten per cent (10%) of the net earnings for the calendar year 1936 is Twenty-two Thousand Dollars ($22,000);
>
> "Now, therefore, be it resolved, that the officers of this Company be and are hereby authorized and instructed to specifically meet the requirements of said Indenture and Section 26 (c) 2 of the Revenue Act of 1936, and to irrevocably surrender to the Trustees, Debentures covered by said Indenture, with all unmatured coupons attached hereto, together with a certificate signed by the President or the Vice President, or the Treasurer of the Company, as to the price which the Company paid for such Debentures, and that such amount of Debentures to be irrevocably surrendered before December 31, 1936, shall have cost the Company not less than Twenty-two Thousand Dollars ($22,000)." (R. 17-18.)

During the year 1936 taxpayer had purchased out of its net earnings for 1936, from the holders thereof, and at a cost of not less than the principal amount thereof, debentures in excess of the principal amount of $47,000, and on December 16, 1936, deposited with the sinking fund trustee debentures with a face value of $47,000, pursuant to directorate authority contained in the above quoted resolution. Of this amount $25,000 was required under the Indenture to be paid on or before January 1, 1937, and the balance, $22,000, represented approximately 10% of the estimated net earnings of the taxpayer for the taxable year 1936. (R. 8.) The $47,000 principal amount of debentures so deposited with the trustee on December 16, 1936, were then cancelled and cremated. (R. 9.)

Subsequent to December 16, 1936, the taxpayer determined that its net earnings as defined by the Indenture for the calendar year ending December 31, 1936, were only $209,493.62 and that the credit to which it was entitled as against adjusted net income was only $20,949.36 as opposed to the $22,000 specified in the resolution of the Board of Directors of December 14, 1936. The taxpayer filed its income tax return on the accrual basis. (R. 9.)

The Commissioner refused to allow any part of such sum as a credit (Statement, R. 5) and upon petition of the taxpayer to the United States Board of Tax Appeals for a redetermination of an alleged deficiency in surtax the Board overruled the Commissioner's determination and allowed a credit of $20,949.36. (R. 9.) This order of the Board was subsequently affirmed by the Circuit Court of Appeals for the Sixth Circuit (Decree R. 19) and an order allowing certiorari having been entered by this Court the within proceedings are to review the judgment of the Circuit Court of Appeals.

IV. SUMMARY OF ARGUMENT.

The amendments to the legislation which subsequently became Section 26 (c) (2) of the Revenue Act of 1936, including other provisions of said Act, clearly manifest an intent on the part of Congress to allow a credit against adjusted net income where payment of an amount equal to a percentage of earnings and profits is postponed until after the end of the taxable year in order that the payment will include a portion or percentage of the profits of an entire year. It is a fundamental principle of statutory construction that the intention of the legislature is the most important guide and that it will be presumed that unfair and undue hardships are not intended; that in the case of taxing statutes imposing a burden of special or unusual character (as was the imposition of the surtax on undistributed profits[1]), where there is doubt or ambiguity in the terms of such a statute, every intendment is to be indulged against the taxing power and in favor of the taxpayer. Taxation is a practical matter and the substance of the thing done and not the form it takes must govern.

The covenant of the taxpayer to create a sinking fund for the security of the bonds issued under the contract by paying into such fund on or before April 1 of each year an amount equal to 10% of its net earnings for the preceding calendar year created an equitable lien upon such percentage of earnings when earned which was enforceable against such earnings for the benefit of the bondholders in the same manner as a lien upon specific things existing at the date of the contract. The taxpayer, by its contract, had assumed an obligation fiduciary in nature and subject to equitable cognizance and was under a duty to irrevocably set aside such percentage of earnings within the taxable year. It is one of the maxims of equity that "equity re-

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[1] This statute was repealed in 1939 after several amendments still proved that the theory of the original law was either impractical or obsolete. 3 Prentice-Hall, Fed. Tax Serv. (1942) 50,241.

gards as done that which ought to be done" and this covenant of the taxpayer was subject to enforcement by suit for specific performance. The contract thus constitutes an agreement to irrevocably set aside a percentage of earnings and profits within the taxable year and therefore to the extent that such constituted 10% of its net earnings the taxpayer is entitled to a credit under Section 26 (c) (2) of the Revenue Act of 1936 in determining its undistributed net income as defined in Section 14 (a) (2). The action of the Board of Directors of taxpayer on December 14, 1936, in authorizing its officers to meet the requirements of its contract by irrevocably surrendering within the taxable year the equivalent in bonds of the specified portion of its earnings for the taxable year, and their subsequent action in so doing, constituted a clear and unequivocal recognition by the taxpayer of the equitable lien so acquired by the debenture holders and constituted a compliance with the requirement of the contract that such amount be irrevocably set aside within the taxable year.

In interpreting the credit provisions of Section 26 (c) (2), the United States Board of Tax Appeals has consistently adhered to the principles early announced by it in the *Strong Manufacturing Company* case which was subsequently affirmed by the Circuit Court of Appeals for the Sixth Circuit. It is further suggested that there is no conflict of opinion or authority between the various Circuit Courts of Appeal nor error in the result reached by the Circuit Court of Appeals for the Sixth Circuit in the instant case.

V. ARGUMENT.

A. The amendments to the legislation which, when enacted, became Section 26 (c) (2) of the Revenue Act of 1936, including other provisions of said Act, show an intent on the part of Congress to allow a credit herein.

The Revenue Act of 1936, c. 690, 49 Stat. 1648, provided a new method of taxing corporations by imposing a surtax upon undistributed net income. Its purpose was clearly to force the distribution of profits into the hands of shareholders where they would be subject to an income tax.[1] As originally introduced in the House of Representatives (H. R. 12395, 80 Cong. Rec. 5978) it contained five schedules of tax rates—Sections 13 to 17, inclusive—providing for the relief of deficit, debt-laden and dividend restricting contract corporations. Such required the determination of earnings from the beginning of the corporate life and projected their application a minimum of five years into the future. (Sections 14 and 16 of Appendix B to Commissioner's Brief. See also Seidman's Legislative History of Federal Income Tax Laws, pp. 217-223.) Yet, when the matter was considered by the Senate Finance

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[1] As stated by the Committee on Ways and Means of the House of Representatives:

"The major purposes of the change in the method of taxing corporate incomes are (1) to prevent avoidance of surtax by individuals through the accumulation of income by corporations, (2) to remove serious inequities and inequalities, and (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates. • • • Corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenues of the United States and to the detriment of the shareholder. The bill proposes to remove many of these inequities by relieving from tax corporations which distribute all their net earnings annually as earned, and by taxing corporations accumulating their net income at a rate to compensate to a large extent for the amount of tax on the shareholders' income lost by reason of the failure to make a complete distribution. • • •" (H. of Rep. Rept. No. 2475, 74th Congress, 2nd Sess. Cum. Bul. 1939-1 (part 2) 667, 669.)

Committee the House Bill was altered in major respects. That committee restored the old form of taxing corporate incomes and superimposed a surtax upon undistributed profits. It eliminated the back-earning history (Section 14) and the projection far into the future of the liquidation of debts (Section 16) by use of the language "*during* the taxable year." (Ibid. pp. 216-217.)

On the floor of the Senate the Bill was subject to more violent criticism than in the House (Paul and Mertens Law of Federal Income Taxation, 1939 Supp.; 1393-1396, Section 32 A. 03), the Finance Committee changes were again rewritten and present Section 26 (c) (2) was finally adopted as an amendment with the consent of the Senate Finance Committee.[1]

Section 26 (c) (2) as finally enacted contained two important features to which comment will now be directed, to-wit:

(1) The concluding sentence of this sub-section referring to an amount equal to a percentage of earnings and profits now appeared for the first time; and

(2) The phrase "within the taxable year" was used instead of "during the taxable year" as first appeared in the Senate Finance Committee draft:

---

[1] "Mr. Couzens: Mr. President, this amendment was generally discussed in the committee; and in view of the language of the bill there were left out, in the judgment of the committee, other forms of debt than those dealing with the payment of dividends. The last words on line 22, page 53 [the proposed Section 26 (c) (1) which afforded a credit in the case of a contract which prohibited payment of dividends *during* the taxable year], seem to exclude obligations of the corporation to pay debts or withhold earnings for specific purposes under contract.

"I have consulted those on the committee, and so far as the committee is concerned, there seems to be no reason for not adopting the amendment." (80 Cong. Record, 9071.)

1. The incorporation in Section 26 (c) (2) of the provision that a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits.

The concluding sentence of Section 26 (c) (2) so added before enactment is as follows:

> "For the purpose of this paragraph, a requirement to pay or set aside an *amount equal to a percentage* of earnings and profits shall be considered a requirement to pay or set aside such *percentage* of earnings and profits." (Emphasis ours.)

It is submitted that this added provision is most significant in construing the intent of Congress as expressed in Section 26 (c) (2) of the Act. First Congress provided that a credit was obtainable by paying or setting aside a *portion* of the *entire year's* earnings and profits and then provided that a requirement to pay or set aside an *amount equal to a percentage* of such earnings and profits should be considered as a requirement to pay or set aside such *percentage* of earnings and profits. Such a declaration is most persuasive of the fact that Congress intended that Section 26 (c) (2) should be liberally construed and that under such a construction the allowance of a credit in the instant case is manifestly proper. If otherwise considered we pose the inquiry—how can an amount based on a percentage of earnings be determined until the year is ended and the books are closed? Accruals, last minute transactions, the time necessary to take and value inventories, the closing of books, the ascertainment of Federal taxes, the determination of earnings to which a percentage can be applied—all take time.[1] Until earnings, therefore, are determined, the amount to be set aside can not become fixed

[1] It is common knowledge that the ascertainment of the net earnings of manufacturing is impossible of determination until after the close of the taxable year. This fact is recognized by Article 22 (c)-1 of United States Treasury Regulations 94 (relating to the Revenue Act of 1936) wherein it is stated:

(Continued on next page)

and of necessity, the phrase "within the taxable year" must mean "within the taxable accounting year"; otherwise the percentage provision of the statute would be wholly ineffective except as to banks and trust companies which are, however, exempt from the undistributed profits tax.[1]

In the administration of income tax laws a common sense interpretation and ordinary everyday business standards should be followed. This principle has repeatedly been announced by this Court and the lower Federal Courts in the following language:

> "Taxation is a practical matter and those practical considerations which support the treatment * * * are the same. * * *." *Harrison v. Schaffner*, 312 U. S. 579; 85 L. Ed. 1055 (1941).
>
> "It has been too often said to warrant citation that taxation is an intensely practical matter and that the substance of the thing done and not the form it took, must govern. This principle has been repeatedly invoked by the Commissioner and applied by the Board. *Carter Publications, Inc. v. Commissioner*, 28 B. T. A. 160; *Warner Co. v. Commissioner*, 26 B. T. A. 1225; *George Whittell & Co., Inc. v. Commissioner*, 34 B. T. A. 1070."
>
> *Commissioner v. Ashland Oil & Refining Co.*, 99 F. (2d) 588 (C. C. A. 6, 1938). Certiorari denied 306 U. S. 661, 83 L. Ed. 1057, 59 S. C. 786.

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[1] It is to be noted that only banks and trust companies can accurately determine their net earnings as of the last day of the taxable year without taking inventory and are, therefore, the only taxpayers which could comply with Section 26 (c) (2) as interpreted herein by the Commissioner. Yet such institutions are wholly exempt from the surtax on undistributed profits. (c. 690, Title I, Section 104; 49 Stat. 1677.)

(Continued from preceding page)

"Art. 22 (c)-1 *Need of inventories.* In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *"

To the same effect are:

Rhodes v. Commissioner, 100 F. (2d) 966 (C. C. A. 6, 1939);

Welch v. Helburn, 5 F. Supp. 581 (Dist. Ct. Ky. 1933).

2. The use in Section 26 (c) (2) of the phrase "within the taxable year."

We also consider as important and significant the fact that the Senate floor amendment as finally enacted changed the phrase "*during* the taxable year" (originally appearing in the Finance Committee draft) to the phrase "*within* the taxable year" in view of the interpretation given the latter phrase in decisions of the Courts and of the United States Board of Tax Appeals in the case of deductions for bad debts under Section 23 (k) of the Revenue Act of 1936. This latter section—as well as all preceding Revenue Acts as far back as 1918—provides that "debts ascertained to be worthless and charged off *within* the taxable year * * *" are deductible from gross income in arriving at net income. This statutory language has been construed almost without exception and without legislative change to allow a deduction for bad debts physically charged off in the first months of the succeeding year as of the preceding taxable year.

Thus, in *Mason Machine Works Co.*, 3 B. T. A. 745 (1926), acquiesced in by the Commissioner, the phrase "charged off within the taxable year" was interpreted, and the Board stated at page 750:

> "This language must be interpreted in the light of the ordinary course of business practice. It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence of the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof."

In *George H. Fraser*, 6 B. T. A. 997 (1927), acquiesced in by the Commissioner, the Board again discussed this phrase, and stated at page 1002:

> "An interpretation of the statute which would deny any deduction except when a charge-off was made upon books of account within the limits of the calendar year, especially when it is considered that closing entries are not usually made until after the close of the year, would work a hardship which we cannot believe was intended or is required and would attach to acts which are merely clerical an importance as great as is to be given to the substance of the situation. The statute must be given a reasonable interpretation, if possible. * * *"

In *Chicago Ry. Equipment Co. v. Blair*, 20 F. (2d) 10, C. C. A. 7 (1927), the Court had before it a bad debt deduction under the Revenue Act of 1918, and stated at page 12:

> "* * * counsel places great stress upon the fact that he said that the entries were not made until January or February, 1919. The only other witness testifying on that point said: 'During the year 1918, we charged off something like $60,000; that is, at the expiration of 1918. * * *' We are of opinion that it was error to hold that they were not bad accounts and charged off *within the taxable year.*" (Emphasis ours.)

In *Jones v. Commissioner*, 38 F. (2d) 550 (C. C. A. 7, 1930), the Court again had the question before it under the Revenue Act of 1921, and stated at page 553:

> "The mere fact that the calculation for the income tax return was not made until some time between December 31, 1921 and March 15, 1922, ought not to be, and is not, controlling in determining when decedent ascertained and determined that the debt was worthless for the law does not require the calculation to be made *within the taxable year.*" (Emphasis ours.)

In the recent case of *Hamlen v. Welch*, 116 F. (2d) 413 (1940), decided by the First Circuit and involving the construction of Section 23 (k) of the Revenue Act of 1934, the Court at page 419 said:

> "We are also of the opinion that the debt was 'charged off within the taxable year' within the meaning of the statute. The statutory language has been construed many times without legislative change to allow a deduction for bad debts physically charged off in the first months of the succeeding year as of the preceding taxable year. [Citing cases.] The decisions of the Board of Tax Appeals have, in the majority of cases, been specifically acquiesced in by the Commissioner; and in the light of this circumstance and the frequent repassage of the identical language in subsequent revenue acts, we believe the interpretation of the statute to be well established to include the instant case.
>
> "Ordinary business practice necessitates the allowance of a reasonable time after the close of the year for the auditing of the books and the physical notation of the closing entries of profit and loss. It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence as to the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof in order that such entries will effectually eliminate the amount of the bad debt from the book assets of the taxpayer, *Commissioner v. MacDonald Engineering Co.*, 7 Cir., 1939, 102 F. (2d) 942, 945; *Kentucky Rock Asphalt Co. v. Helburn, supra*; *Mason Machine Works Co., supra*; see III *Paul & Mertens, The Law of Federal Income Taxation* (1934), Sec. 28, 30. In the instant case the entries were made to profit and loss in January or February, 1936, as of December 31, 1935. This is enough to bring the case within the law as construed. *Cf. Coon Valley State Bank*, 1928, 13 B. T. A. 132; *Ed. C. Lasater*, 1925, 1 B. T. A. 956 (entries not made as of the taxable year)."

In *Kentucky Rock Asphalt Co. v. Helburn*, 20 F. Supp. 364 (Dist. Ct. Ky. 1937), (affirmed 108 F. (2d) 779, C. C. A.

6; 1940) the deduction was disallowed on other grounds, but the Court said at page 368:

> "As I have heretofore stated, the administration of the income tax revenue statute is concerned with practical things, and it is hardly feasible for the officers of a corporation to immediately determine at the close of the year deductible bad debts. While the language used in the act provides that the ascertained bad debts shall be 'charged off within the taxable year,' it is not to be presumed that the Congress intended this language to mean all entries on the books of a corporation should be made and the books closed at midnight of the day the taxable year ended. As a practical matter, many facts are assembled as a basis for the book entries after the close of the year and the Congress did not intend there should be an essential departure from the usual course of business in making book entries in order to comply with the income tax laws."

In the case at bar the payment was made during the taxable year, to-wit, December 16, 1936, although the exact amount to be determined by percentage was not required to be ascertained by Ernst & Ernst until April 1 of the succeeding year—or fifteen (15) days after the 1936 Federal income tax return was due. It is respectfully submitted that the determination and payment of the stated percentage of the net earnings of the taxpayer must be considered as being called for by the contract as of the taxable year and that the same complies with the requirements of Section 26 (c) (2). To hold otherwise would be to disregard the plain intent of Congress as expressed in the concluding sentence of that section to the effect that a requirement to pay or set aside an *amount equal to a percentage* of earnings shall be considered a requirement to pay or set aside such *percentage* of earnings.

3. The difference of language in the two grounds for credits under Section 26 (c) (2).

Attention is also called to the difference of language in the two grounds for credits under Section 26 (c) (2), viz., "* * * the portion of the earnings and profits * * * which is required * * * to be paid within the taxable year *in* discharge of a debt, or to be irrevocably set aside within the taxable year *for* the discharge of a debt. * * *"[1] (Emphasis ours.)

Clearly, the first ground for a credit contemplates that an actual payment must be required by contract to be made within the taxable year *in* the discharge of a debt. The second ground for a credit contemplates that the irrevocable setting aside must be effected within the taxable year in anticipation of or on account of a future payment. In other words, payment can be postponed until after the taxable year but the requirement is that the setting aside be effected within the taxable year. The use of the word "in" in the first instance denotes the discharge of a debt by the payment thereof in the present taxable year, while the use of the word "for" in the second instance is in the sense of futurity or time to come. The inclusion within Section 26 (c) (2) of the second ground for a credit shows that Congress contemplated situations like in the instant case where payment was postponed until after the close of the taxable year when a determination of the net earnings could be properly had and the required percentage of such earnings applied for the discharge of the debt. A percentage is a part of the whole and until the earnings for the whole or entire year are ascertained, a portion or percentage thereof remains an unknown quantity. Hence, the reason for the concluding sentence of Section 26 (c) (2).

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[1] This distinction is disregarded when referred to in the Commissioner's Brief, pp. 10, 13.

B. Section 43 of the Revenue Act of 1936 further clarifies the intent of Congress to the effect that Section 26 (c) (2) permits a percentage of earnings to be paid or accrued within the taxable year.

Section 43 of the Revenue Act of 1936, insofar as it applies to corporations, reads as follows:

> "The deductions and credits (other than the dividends paid credit provided in Section 27) provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

Sections 26 and 27 of the Revenue Act of 1936 are companion sections. They both relate to credits to corporations pertaining to dividends and are the two grounds for credit enumerated in Section 14 (a) (2) defining "undistributed net income." Still in Section 43 allowing credits for the taxable year in which such are *paid* or *accrued* Congress saw fit to exclude only Section 27. This parenthetical clause:

> "other than the dividends paid credit provided in Section 27)"

is new in the 1936 Act. The same language, *excluding* the parenthetical clause, appears in Section 43 of the Revenue Act of 1934. Congress, therefore, deliberately excluded only Section 27 from the time for taking credits, and this specific elimination of the Dividends Paid section clearly indicates the inclusion of the other section i.e. Contracts Restricting Payment of Dividends—as one where accrual is permitted. And since the taxpayer was on an accrual basis (R. 9) and also *paid* the estimated sinking fund requirements *within the taxable year* (R. 9, 18), it would appear that it was entitled to the claimed credit for 1936 on either method of accounting, cash or accrual.

There is good reason for the *inclusion* of Section 26 allowing an accrual of amounts paid or set aside within the taxable year to pay debts and the *exclusion* of Section 27 which disallows an accrual for dividends. As already stated the general purpose of the 1936 Act was to raise revenue by forcing corporations to distribute net earnings and if dividends could be accrued without payment to shareholders the professed purpose of the Act would be circumvented. The payment of a debt does not (apart from the slight possibility of capital gains) create taxable income for the holder of the obligation, whereas the payment of a dividend does in most instances result in an income tax.

There is also a further reason for this differentiation between Sections 26 and 27. In Section 27 the word "during" precedes the words "taxable year" four times and the word "within" does not appear at all; whereas, in Section 26 the word "within" precedes the words "taxable year" three times and the word "during" appears only in paragraphs (d) and (e) where the context clearly shows the necessity for the changed wording. Both Section 26 (c) (2) and Section 43 are within Title I of the Act, and since Section 27 is specifically excepted, it tends further to substantiate the contention of the taxpayer that Section 26 (c) (2) permits a percentage of earnings to be paid or accrued within the taxable year.

This Court has heretofore said in *United States v. Anderson*, 269 U. S. 422, 70 L. Ed. 347 (1926) that a Departmental regulation authorizing the use of the accrual method of accounting was adopted in order to enable taxpayers to keep books and make returns according to scientific accounting principles. The taxpayer adhered strictly to this principle. As will be hereinafter urged in this brief it was legally obligated to accrue 10% of its earnings for the taxable year in discharge of its indebtedness and it so computed the amount with reference to the probable earnings shown by its books and actually made payment within the taxable year of the amount so accrued.

It is not unusual for a corporation to make similar accruals for various purposes in closing its books. If it were not permitted to do so Section 26 (c) (2) would be practically voided by the interpretation placed thereon by the Commissioner because he must necessarily hold on the same theory that a payment made during the succeeding year related to the disposition of earnings of a *prior* year rather than of the taxable year during which payment was made. During the entire course of this controversy the Commissioner has never shown how Section 26 (c) (2) should be construed to give relief to a corporation required by contract to pay a percentage of its *entire year's* earnings if effect is to be given to the concluding sentence of that Section. Only now by his brief herein (Note 12, page 20) does he attempt any such suggestion but he still omits all reference to such concluding sentence. His suggestions, however, have little merit when we consider that all contracts in which the question may arise must of necessity have been executed prior to the enactment of the statute and hence have been drafted without thought of meeting in terms the statutory requirement because none then existed.[1] To suggest therefore that relief would be avail-

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[1] Thus in *Chess & Wymond, Inc. v. Glenn, Collector*, 40 F. Supp. 666 (Dist. Ct. Ky. 1941) the Court said on p. 670:

> "It will be noticed that the statute was enacted on June 22, 1936, which was more than six months after the agreement under consideration was entered into. If the statute had been in existence at the time of the negotiations between the plaintiff and the bank, it would have been comparatively easy to have executed a written contract complying in every respect with the provisions of the statute, and no doubt attention would have been given to precisely meeting those requirements. In such a case the formal contract should be strictly and literally construed. But the Court should consider the question from a much more liberal viewpoint when it analyzes a written agreement, informally entered into without intending to comply with any statutory requirements, because none existed, and without any thought or suggestion that it would be later tested for exact compliance with the provisions of a statute subsequently enacted and that it would be declared invalid if it did not meet that pattern in every detail."

able had the corporation contracted to pay upon the basis of quarterly statements or upon an approximation of net earnings would be shutting one's eyes to the plain facts and dealing with the question in an intellectual vacuum. Losses and unusual expenses incurred in a final quarter may very well exhaust earnings of the preceding quarters. Certainly Congress never intended the result urged by the Commissioner when it enacted Section 26 (c) (2) nor did it intend that the Commissioner should apply such a technical and unrealistic interpretation of this Section when such an obviously unfair consequence would be attained. As stated in *Morill v. Jones*, 106 U. S. 466, 27 L. Ed. 267 (1883), the authority given to the Secretary of the Treasury to make rules and regulations for the administration of the Revenue laws does not include the power to alter or amend such laws.

A regulation to be valid must be consistent with the statute and also reasonable. A regulation which "operates to create a rule out of harmony with the statute is a mere nullity." *Manhattan General Equipment Co. v. Commissioner*, 297 U. S. 129, 80 L. Ed. 528 (1936).

C. The contract required the taxpayer to "irrevocably set aside within the taxable year for the discharge of a debt" "an amount equal to ten per cent (10%) of the net earnings" for the discharge of a liability which had accrued within the taxable year.

It is the contention of the taxpayer that the covenant to pay to the Indenture Trustee on the next succeeding April 1, an amount equal to 10% of its net earnings for the taxable year constituted an agreement to "irrevocably set aside" such earnings "within the taxable year." By his action in refusing to allow the credit in question the Commissioner failed to recognize that the liability to set aside such an amount for the year 1936 had accrued although not ascertained as to exact amount until audit

was completed by April 1 of the succeeding year. Taxpayer was under a contractual duty to hold for the discharge of that liability a sum equal to 10% of its earnings—an obligation which the Trustee could have enforced in equity had taxpayer attempted to dispose of such sum and thereby threaten an impairment of the security to which the debenture holders were equitably entitled. Such percentage of income became impressed with a trust and a court of equity would clearly say that the postponing until April 1 of the date of payment was a matter of convenience only because the events necessary for the accrual of the liability had taken place by the end of the year and there remained only the ascertainment of the exact amount after an examination of the incidents of profit and loss. Only delivery of the sum was deferred by the terms of the contract until a proper audit could be completed but such audit could not change the actual result of the 1936 earnings of the taxpayer. It could merely verify those earnings and report the results shown by the books. The mere fact that upon final audit 10% of the actual earnings were shown to be only $20,949.36 instead of $22,000 as estimated by taxpayer on December 14, 1936, cannot change its obligation to accrue the amount of the debt within the taxable year.

The existence of an equitable lien in favor of bondholders and the right of the Trustee to restrain the disposal of corporate assets was recognized in *Marine Midland Trust Co. v. Allegheny Corporation*, 28 F. Supp. 680 (Dist. Ct. N. Y., 1939) where the Court found that the Corporation had covenanted to maintain collateral at 150% of the principal amount of the outstanding bonds and held that such was an obligation which the Trustee could properly seek to enforce in equity. Said the Court on page 683:

> "In fact any other construction would be unjust both to the bondholders who invested their money re-

lying on the representation and to those who officially executed the indenture in the honest belief that it was 'designed to carry out the intent of the corporation' as expressed in the representation. We are not to assume that they intended to do less than they had promised. They evidently intended to meet the terms of the offering circular. * * * Assuming that the defendant had covenanted to maintain the collateral at the 150% ratio, there are legal precedents for the enforcement of that covenant by suit for specific performance," citing *Greenleaf v. Blakeman*, 40 App. Div. 371, 58 N. Y. S. 76, affirmed *Greenleaf v. Schley*, 166 N. Y. 627, 60 N. E. 1111; *McNamara v. McNamara*, 256 App. Div. 370, 10 N. Y. S. 2d 94; *Hicks v. Turck*, 72 Mich. 311, 40 N. W. 339; *Pomeroy* Sec. 2175.

In *Morse v. Bay State Gas Co. of Delaware*, 91 Fed. 938 (Cir. C. Del., 1897) a demurrer had raised the question as to the right of the holders of income bonds to bring an action in equity and the Court in overruling the same said:

"But, again, it is contended that no duty was assumed with which a court of equity is competent to deal; that what is set up amounts to but a breach of contract. I can not assent to this. Those who took these bonds did not, as has been pointed out, accept mere promises to pay. They, of course, relied, and had a right to rely, upon the fidelity of the corporation for the production, protection, and application of net earnings, and by its necessarily implied undertaking to exercise good faith in this regard the corporation assumed an obligation which was fiduciary in its nature, and which, therefore, is of equitable cognizance."

In *Geddes v. Reeves Coal & Dock Co.*, 20 F. (2d) 48 (C. C. A. 8, 1927) the Court said at page 50:

"The general principles, rules and practice in equity applicable to this case have been stated by Pomeroy and his statement of them has been adopted and confirmed by repeated decisions of the Supreme Court and of others courts. He wrote: 'Every ex-

press executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforcible against the property in the hands not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees and purchasers or encumbrancers with notice.' 3 *Pomeroy's Equity Jurisprudence*, Sec. 1235.

"'It is well settled that an agreement to charge, or to assign, or to give security upon, or to affect property not yet in existence * * * or property to be acquired by him in the future * * * does constitute an equitable lien upon the property so existing or acquired at a subsequent time, which is enforced in the same manner and against the same parties as a lien upon specific things existing and owned by the contracting party at the date of the contract.' 3 *Pomeroy's Equity Jurisprudence*, Sec. 1236."

In *Klaustermeyer v. Cleveland Trust Co., Assignee*, 89 O. S. 142, 105 N. E. 278 (1913) Klaustermeyer, a director in The Euclid Avenue Trust Company, agreed with others to loan the bank $5,000 upon the condition that each of them should be given security for the loan from certain collateral securities owned by and in possession of the bank. The loan was made but Klaustermeyer neither received any securities as collateral nor were any securities segregated for him by the bank. The bank subsequently made an assignment for the benefit of creditors and in holding that Klaustermeyer had an equitable lien on the assets of the bank, the Supreme Court of Ohio said at page 147:

"Now, one of the fundamental maxims of equity is, '*equity regards as done that which ought to be done.*'

"'The broad meaning of this maxim is that where an obligation rests upon a person to perform an act equity will treat the person in whose favor the act should be performed as clothed with the same interest

and entitled to the same rights as if the act were actually performed. It is closely connected with and probably derived from the principle of regarding intent and substance rather than form. * * * The principle also lends its force to the establishment of liens and charges which could not be sustained at law, and to working out justice by fixing *rights as of the time when the obligation first accrued*, rather than according to circumstances subsequently arising.' 16 *Cyc.* 135." (Italics the court's.)

In *Barnes v. Alexander*, 232 U. S. 117 (1914), Barnes was employed as an attorney upon a contingent fee of one-fourth and promised Alexander and Street one-third of this one-fourth if they would handle the case. The Court held that this promise created a lien upon the fund the moment it was received by Barnes. See also *New York Trust Co. v. Michigan Traction Co.*, 193 Fed. 175 (Dist. Ct. Mich., 1912).

An equitable charge or interest having been created by the provisions of the contract in favor of the debenture holders to the extent of 10% of the net earnings of the taxpayer during the taxable year, such debenture holders as equitable incumbrancers had an equitable lien upon such percentage of earnings. (*Restatement of the Law of Trusts*, Vol. 1, section 10 (a).) And since the Trustee had a right to enforce such obligation and lien, must it not be said that the contract required as a matter of law that such percentage of earnings be irrevocably set aside within the taxable year? Implied conditions in a contract are as effective as express conditions once they are established and the corporation with a written contract containing implied conditions is certainly as entitled to a credit as a corporation having a contract with express conditions.[1] The action of the Board of Directors of taxpayer on December 14, 1936, in adopting the resolution authorizing the

[1] Section 26 (c) (2) only requires that the provisions of the contract *expressly* deal with the disposition of earnings and profits of the taxable year.

officers specifically to meet the requirements of the Indenture and of Section 26 (c) (2) of the Act by irrevocably surrendering to the Trustee the necessary amount of debentures, is a clear and unequivocal recognition by the taxpayer that its debenture holders had acquired an equitable lien during the taxable year upon 10% of its net earnings and constituted compliance with the requirement of the contract that such amount be irrevocably set aside within the taxable year. The taxpayer herein was manifestly under a fiduciary duty to irrevocably set aside 10% of its net earnings and to make it clear that it had done so it paid the estimated requirements within the taxable year, and if in so doing it did more than it was required by the contract, it still comes within the statute since a part of what it did—the inevitable "drawing on current earnings, thus removing current earnings as a source of dividend payments"[1]—it was required to do by the contract. It must also be remembered as this Court has already said in *Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46 (1940) "* * * the surtax is imposed upon the annual net income *only if it is not distributed*, * * *." (Emphasis ours).

D. An analysis of Section 26 (c) (2), the conditions it imposes, and decided cases.

1. Introductory statement.

Section 26 (c) (2) imposes the following conditions:

(1) That there be a written contract executed by the corporation prior to May 1, 1936.

(2) That there be a provision which expressly deals with the disposition of earnings and profits of the taxable year—

(3) (a) To be paid within the taxable year *in* discharge of a debt; or

[1] *G. B. R. Oil Corporation v. Commissioner*, 40 B. T. A. 738 (1939).

(b) To be irrevocably set aside within the taxable year *for* the discharge of a debt.

(4) A requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits.

(5) When the above conditions are met a credit may be given to the extent that such an amount has been paid or set aside.

The Commissioner by Brief (p. 14) concedes the existence of (1) and (2), leaving the issue confined to a consideration of the remaining conditions. And as heretofore urged we believe the phrase "within the taxable year" in (3) should be construed in such a manner as to give effect to the percentage provision contained in (4). There is no question but that the deposit of bonds of December 16, 1936, effected a compliance with (5). The sum under consideration herein has been subject to a normal tax and was distributed within the taxable year. The broad issue is whether they are now subject to a further tax as "undistributed" in spite of the fact that they have been distributed pursuant to the provisions of the contract which removed them as a source of dividend payment.

2. In interpreting the credit provisions of Section 26 (c) (2) of the Revenue Act of 1936, the Board of Tax Appeals has reaffirmed the principles announced in its decision in Strong Manufacturing Company.

Section 26 (c) (2) early came up for decision in *G. B. R. Oil Corporation v. Commissioner*, 40 B. T. A. 738 (1939), in which the taxpayer corporation borrowed money from a bank to use in the purchase of oil leaseholds. The bank was secured by deed of trust liens on the properties and also by assignments of the taxpayer's interests in the properties in trust, which assignments authorized the bank to receive and collect all sums of money derived from the properties and to apply the same on the indebtedness to

the bank. The bank credited the payments it received from the taxpayer's oil customers to the taxpayer's account, with an understanding that out of the funds deposited nothing would be paid of any character whatever except the actual, necessary and usual operating expenses, and the balance would be applied to the reduction of the loan. The taxpayer's claim for a credit under Section 26 (c) (2) of the Revenue Act of 1936 for all of the amounts paid to the bank in 1936 under this arrangement was allowed by the Board, which said in part at page 744:

> "The general purpose of section 26 (c) (2), it seems to us, is to give a credit where a dividend paid credit can not be secured. In other words, the basic intent of Congress seems to have been to include in the provision only contracts which inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments. See *Paul and Mertens*, par. 32 A. 46, 1938, cumulative supplement."[1]

The application of Section 26 (c) (2) next arose in *Michigan Silica Company v. Commissioner*, 41 B. T. A. 511 (1940) where the taxpayer was engaged in the production and sale of sand and was required by contract to pay to a trustee under a bond indenture the sum of 25 cents per ton for sand sold. The taxpayer made a payment in January 1937 for the sand produced and sold in December 1936.

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[1] In *Chesapeake Ferry Company v. Early, Jr., Collector* (Memo. Op.), 39—2 U. S. T. C. Sec. 9786, p. 10,923 (Dist. Ct. Va., 1939) the court at first denied a credit claimed under Section 26 (c) (2) of the Revenue Act of 1936 for sinking fund payments made under a deed of trust. However, after the *G. B. R. Oil Corporation* case, *supra*, had been decided, the court filed an "Additional Memorandum" saying in part (p. 10,924):

> "Upon rehearing and reconsideration and in the light of the Board's decision (in the *G. B. R. Oil* case) above quoted, I am of the opinion that the provisions of the deed of trust in question 'inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments,' and that petitioner is entitled to the relief sought."

In allowing this payment as a credit in the determination of the 1936 tax the Board said at page 515:

> "Since it would be impossible to compute any monthly payment due the sinking fund here until after the close of the month, the contested credit shall include the payment for sand sold during December of the taxable year, 1936, even though that payment was not physically made until January 1937. This seems proper on the theory that such payment was made *as of* December, 1936." (Italics the Board's.)

In *Strong Manufacturing Co. v. Commissioner*, 41 B. T. A. 1273 (1940) (now pending in this Court to review a judgment of the Circuit Court of Appeals for the Sixth Circuit, *Helvering v. Strong Manufacturing Co.*, 124 F. (2d) 360 (1941)), the contract required the taxpayer to apply 40% of its net earnings for any calendar year in discharge of the debt, settlement to be made not later than April 15 of the succeeding year. The Board allowed the credit under Section 26 (c) (2), stating on page 511;

> "On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, *Michigan Silica Co.*, 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled."

Subsequent to its decision in the *Strong* case the Board has decided a number of cases involving the application of Section 26 (c) (2) of the 1936 Act but an examination of such shows that although in many cases it has denied credits under different facts, it has adhered to the principles laid down in the *Strong* case and followed in *The Ohio Leather* and *Warren Tool Corporation* cases. In so doing, however, it has constantly applied the principles of *New Colonial Ice Co. v. Helvering*, 292 U. S. 435,—that in order to avail itself of a deduction the taxpayer must carry the burden of establishing that it comes within the precise language of the statute but in so doing it has adhered to its reasoning in the decisions now on review before this Court.

Of the recent Board cases the one nearest in point to the case at bar is *Baltimore Steam Packet Co.*, 44 B. T. A. 629 (1941). The taxpayer in that case was indebted to three banks and on July 31, 1935, renewed its loans for one year by a written agreement including the following provision:

> "That effective January 1, 1936, any Net Income after deductions for depreciation (as the term 'Net Income' is now defined in the accounting regulations and reports of the Interstate Commerce Commission) of the Company from its operations, as reported in its annual reports to the Interstate Commerce Commission, accruing during the life of said loans (by the three banks) * * * to this company, shall be applied to the pro rata reduction of said loans * * *." (Page 630.)

On August 1, 1936 this contract and the three notes were extended and renewed for another year, with minor modifications.

About the middle of December of 1936 the taxpayer estimated its net earnings for 1936 would be about $25,000.00 and paid this amount to the banks. Upon final determination made after the close of the year it was as-

certained that actual net earnings amounted to $25,490.23. On March 13, 1937, it paid the remaining $490.23 to the three banks.

The Board was of the opinion that the entire $25,490.23 was a proper credit under Section 26 (c) (2). On authority of its decisions in *G. B. R. Oil Corporation*, 40 B. T. A.; *Michigan Silica Co.*; and *Joell Co.*, 41 B. T. A. 825, the Board held that the above provision, relating to net income "expressly deals with the disposition of earnings and profits of the taxable year," as it is required by Section 26 (c) (2). Continuing the Board said:

> "There is nothing in the opinion of the Supreme Court in *Helvering v. Northwest Steel Rolling Mills, Inc. supra* (311 U. S. 46) which supports respondent's contention. In that case the Supreme Court held that a corporation which was prohibited by state law from distributing as dividends its profits of the taxable year because of a previously existing deficit was not entitled to a credit under section 26 (c) (1). The Court stated that a provision of the corporation's charter, that it should obey state law, including the statutory prohibition against distributing dividends, was not a provision of a written contract executed by the corporation and thus did not meet the requirements of section 26 (c) (1). The Court's general statement, 'that provisions granting special tax exemptions are to be strictly construed,' does not compel the conclusion in the present case that the provision in question did not deal expressly with the earnings and profits of the taxable year." (Pages 633-4.)

The Commissioner also contended that provision did not require the earnings and profits "to be paid within the taxable year" or "to be irrevocably set aside within the taxable year" and cited *Moloney Electric Co.* and *Northwest Steel Mills*. In answer to this the Board cited and discussed fully *Strong Mfg. Co.* and *Michigan Silica* (requiring payment "as of" the taxable year "and therefore to constitute the irrevocable setting aside contemplated

by the statute"). Then dealing with the *Moloney* case the Board said:

> "*Moloney Electric Co., supra*, which is cited by respondent in his brief, is distinguishable. In that case, under a provision of a trust agreement securing its bonds, the taxpayer was required to pay to the trustee as a sinking fund on the first day of June of every year, as long as the bonds were outstanding, 20 per cent of its net earnings for the next preceding year in excess of $320,000. The Board held that this provision of the trust agreement did not require a portion of the taxpayer's earnings and profits of the taxable year to be paid or irrevocably set aside within the taxable year and that the taxpayer was not entitled to a credit under section 26 (c) (2) with respect to this provision of the trust agreement. The Board distinguished the *Strong Manufacturing Co.* case on the ground that in the *Strong* case 'the taxpayer recognized that under its contract its creditor had an equitable lien, during the taxable year, upon 40 per cent of its net earnings' while in the *Moloney* case 'the creditor had no equitable lien upon (taxpayer's) earnings until and unless they should be in excess of $320,000.'
>
> "It should be pointed out that the record in the present case clearly indicates that petitioner recognized that under the provision in question the three banks had an equitable lien during the taxable year upon its net income (after deduction for depreciation) of that year. The testimony of petitioner's general auditor indicates that petitioner understood that its net income of the taxable year 'belonged to' the three banks; that the three banks had 'an equitable lien' on its net income of the taxable year; and that it was obligated to pay its net income of the taxable year to the three banks at the end of that year. In accordance with this understanding petitioner, about the middle of December of the taxable year, estimated that its net income of the taxable year would be approximately $25,000 and on December 23 of the taxable year paid a total of $25,000 to the three banks. Its net income of the taxable year, as finally determined after the close

of that year, amounted to $25,490.23; and on March 13, 1937, it paid the balance of $490.23 to the three banks.

* * * * *

"Under section 26 (c) (2) the credit allowable is limited to the amount which was actually paid or irrevocably set aside within the taxable year under the provision in question. Petitioner paid to the three banks a total of $25,000 on December 23, 1936, and a total of $490.23 on March 13, 1937, under the provision in question. The payment of $490.23 may be considered as made 'as of' the taxable year. *Michigan Silica Co., supra.* Respondent makes no issue as to the amount of the credit allowable." (Page 636.)

3. There is no real conflict of opinion within the Federal Courts nor was error reached herein by the Circuit Court of Appeals for the Sixth Circuit.

The Commissioner has cited in his brief the cases of *Helvering v. Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8) and *Antietam Hotel Corp. v. Commissioner*, 123 F. (2d) 274 (C. C. A. 4) in support of his contention that the contract in the instant case does not satisfy the requirements of Section 26 (c) (2). It is submitted, however, that the difference is one of facts and that there is no real conflict between the decision in the *Strong Manufacturing Company* case and the cases so cited.

In *Helvering v. Moloney Electric Company*, 120 F. (2d) 617 (C. C. A. 8th, June 9, 1941) the court reviewed the decision of the Board of Tax Appeals in *Moloney Electric Company*, 42 B. T. A. 78. The taxpayer claimed two credits under Section 26 (c) (2) of the Revenue Act of 1936 because of its alleged compliance with the provisions of a trust indenture, the applicable parts of which were:

"Section 1. The Company covenants that as a sinking fund for the retirement of debenture bonds issued hereunder it will pay to the Trustee on the first day of June, 1930, and the first day of each succeeding June thereafter, so long as any of the debenture bonds here-

by authorized are outstanding, a sum equal to 2% of the largest amount of debenture bonds at any time outstanding, and will also pay on said date to the said Trustee 20% of the net earnings, for the next preceding year, as hereinafter defined, of the Company in excess of Three Hundred Twenty Thousand Dollars ($320,000). The determination of the sum to be paid to the sinking fund from the net earnings shall be made from an audit to be made at the close of each calendar year by a firm of certified public accountants acceptable to the Trustee, and when said net earnings are so determined from said audit, which, in no event, shall be later than the first day of each April, *said amount shall forthwith be set aside in a separate fund* by the Company and shall be paid to the Trustee as herein provided on the first day of June of each year, beginning in the year 1930.

* * * * *

"Section 3. The Company may, at its option, at any time redeem all or any part of the debenture bonds then outstanding hereunder. Such redemption shall be upon thirty (30) days' published notice as hereinabove provided, and at the price of One Hundred and Three Dollars ($103.00), and accrued interest to date of redemption, for each debenture bond." (Emphasis ours.)

One credit claimed was for $13,810.00, being 2% of $690,500.00, the largest amount of the bonds outstanding during the taxable year 1936. The other credit claimed was for $31,526.66 being 20% of the net earnings for 1936 in excess of $320,000.00. The 2% credit was allowed by the Board but disallowed by the Circuit Court of Appeals on the ground that the duty to make the payment did not depend upon the presence of earnings in the taxable year.

The taxpayer some time during 1936 retired all of the outstanding bonds and it claimed that in view of the provisions of the trust agreement requiring it to pay the trustee on June 1 of each year 20% of the net earnings of the company for the preceding year in excess of $320,000.00 it was entitled to a credit of 20% of the excess earnings. Both the

Board and the Court of Appeals denied the taxpayer this credit.

The Board of Tax Appeals distinguished its decision in the *Strong Manufacturing Co.* case by saying:

> "The instant proceeding is distinguishable upon its facts from *Strong Manufacturing Co.*, 41 B. T. A. 1273. In the cited case it was found that 'compliance with * * *' (the) conditions' of the statute was questionable in only one respect. It was held that 'the "application" of the designated portion of the earnings and profits required by the contract' was 'to be considered as operative "as of" the taxable year and therefore as the irrevocable setting aside contemplated by the statute.' The contract in that case required the taxpayer to 'apply forty percent (40%) of its net earnings * * * upon the unpaid balance of said purchase price.' The findings show that 'since it appeared (in October of 1936) that petitioner's profits would be such that 40 percent thereof would be in excess of the amount required to discharge the mortgage in full, it was decided to make the payment at that time.' In other words, the taxpayer recognized that under its contract its creditor had an equitable lien, during the taxable year, upon 40 percent of its net earnings. But in the instant proceeding the creditor had no equitable lien upon petitioner's earnings until and unless they should be in excess of $320,000. It has been pointed out above that the evidence is not sufficient to establish this fact; and without it the rationale of *Strong Manufacturing Co.* can not be applied. It is therefore held that the Commissioner did not err in denying petitioner's claim for a credit of $31,526.66 under section 26 (c) (2) *supra.*" 42 B. T. A. at 86, 87.

The Court sustained the Board in its determination that the 20% credit should not be allowed on two grounds: (1) under the terms of the taxpayer's contract it was not required to set aside the 20% of the 1936 excess net earnings until April 1937; and (2) there was no evidence to show whether the payment was made in consideration of the year's earnings and it seemed obvious that the payment

was made under Section 3 of Article III permitting the company at its option to redeem the bonds. The Court's language on these two points at pages 621-2 is as follows:

> "One of the circumstances upon which the right to a credit under Section 26 (c) (2) is conditioned is as stated, that the written contract contain a provision which 'expressly deals with the disposition of earnings and profits of the taxable year.' Another condition imposed by that section is that the payment or setting aside for which credit is claimed must be one which is required to be made within the taxable year. The statute speaks of 'an amount * * * which is required * * * to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt.' *Under the terms of the taxpayer's contract, however, it is clear that the payment or setting aside of 20 percent of the 1936 excess earnings was not required until 1937, the year following the taxable year.* The taxpayer below admitted that payment was not required until June 1, 1937, but urged that the contract 'did require the company to irrevocably set aside within the taxable year 20% of the net earning in excess of $320,000.' It is clear, however, that no irrevocable setting aside was required to be made in 1936 or earlier than April of the succeeding year. The contract requires that when the net earnings are determined from the audit (which is 'to be made at the close of each calendar year'), 'which, in no event, shall be later than the first day of April, *said amount shall forthwith be set aside in a separate fund.*' It follows therefore that one of the terms of the statute has not been met.
>
> "The taxpayer's claim to a credit of $31,526.66 under Section 26 (c) (2) must be denied for an additional reason, which was stated by the Board of Tax Appeals as follows: 'There is no evidence upon which to base a conclusion that any portion of the amount paid in 1936 was paid because of petitioner's obligation to apply 20 percent of its net earnings in excess of $320,000 toward the reduction of its indebtedness. *The record does not disclose whether the payment was made near the close of the year when it was apparent*

that the earnings would be in excess of $320,000 or whether it was made earlier in the year when the earnings were much less than that amount. It seems to be obvious that the payment was made under the option contained in section 3 of article III rather than because of any requirement of the contract that it be made. In any event, in the absence of any showing as to when the payment was made and in the absence of any showing as to the amount of net earnings at that time, it is impossible to find that the payment was made because of the requirement that 20 percent of the net earnings in excess of $320,000 be applied upon the debt."

"For the foregoing reasons, it appears that the Board of Tax Appeals did not err in denying the taxpayer a credit of $31,526.66 under Section 26 (c) (2) of the Revenue Act of 1936."[1] (Emphasis ours.)

Likewise in the *Antietam* case the Court was confronted with entirely different facts and the issue decided in the *Strong* case was never present in the *Antietam* case. The most that can be said about the latter case is that if the Fourth Circuit Court of Appeals *had had to pass* on the question it would have denied the credit. That the taxpayer in the *Antietam* case was in fact in no position to obtain the credit under the principles of the *Strong* case is shown by difference in the facts, a situation recognized by the Board of Tax Appeals[2] for, in denying the credit in the *Antietam* case, it first pointed out that the funds were never segregated during the taxable years but remained in the general bank account. *The credit by the statute is limited "to the extent that such amount has been so paid or set aside."* The Board in the *Antietam* case said:

"We have considered the general question involved in the instant proceeding in two recent opinions. In *Strong Mfg. Co.*, 41 B. T. A. 1273 (Dec. 11, 122), where-

[1] Certiorari was denied by this Court in the *Moloney* case November 10, 1941; rehearing denied January 12, 1942.

[2] Memorandum opinion entered October 23, 1940 and reported C. C. H. Board of Tax Appeals Service, 11,357-A.

in the taxpayer was granted a credit, it appears that the company anticipated its income for the taxable year and actually did make the payments within the taxable year there in question. *Therein the facts differ materially from our instant case.*

"In June of 1940 this Board decided the case of *Moloney Electric Co.*, 42 B. T. A. 78 (Dec. 11, 214), which considered a similar question. In this later case we found against the taxpayer. We said that in the *Strong* case the creditors had an equitable lien throughout the entire taxable year recognized by the taxpayer, whereas in the *Moloney* case the creditor had no equitable lien upon the taxpayer's earnings unless and until they should be in excess of $320,000. While there was a payment of certain moneys within the taxable year by the taxpayer in the *Moloney* case, we said:

> The record does not disclose whether the payment was made near the close of the year when it was apparent that the earnings would be in excess of $320,000, or whether it was made earlier in the year when the earnings were much less than that amount.

"In our instant case (i.e. the *Antietam* case), although the petitioner insists that the bondholders had an equitable lien, the contract expressly provides that they were entitled to nothing provided the net profits, calculated according to the indenture, did not exceed $10,000. Consequently, we have a situation analogous to that of the *Moloney* case with the exception that in our present case nothing was physically transferred within the taxable year. Our lien, if such it be, is closely comparable to the lien of that case. There the Board, although recognizing that a lien may have existed at some time, nevertheless, denied the taxpayer a credit. We must here follow the holding of the *Moloney* case. * * * Furthermore, a stronger factor is here present which was not discussed in the *Moloney* case. There was no actual payment here within the taxable year, nor any visible setting aside of funds. Therefore, it can not be said that all of the requirements of the statute have been fulfilled.

"For the above reasons we must hold in favor of the respondent.

"Decision will be entered under Rule 50." C. C. H. Board of Tax Appeals Service, Dec. 11, 357-A, p. 33,150.

In its opinion the court said:

"Petitioner contends very strenuously that the applicable law of Maryland treats this indenture as an express trust, and that, accordingly, the funds covered by the indenture cannot be diverted from the ultimate use set out in the indenture without the violation of a duty under the trust. Consequently, petitioner claims that there was in this case an irrevocable setting aside of the funds by operation of law. *It is clear from the record, however, that these funds were never actually segregated* from the taxpayer's other moneys during the taxable years in question. Indeed, the evidence discloses that during the taxable years in question, *the funds actually remained in petitioner's general bank account, and it is quite clear that actual payments to the Trustee were not made during the taxable years* but were, in each instance, paid by check during March of the year after the taxable year. Thus, *there was no definitive act within the taxable year which divested the corporation's control over the funds.*" (Emphasis ours.) (123 F. (2d) 274, 276.)

After the Court quoted Regulations 94, Art. 26 (c) (2) set out in full in the Appendix, the Court said:

"Thus, it will be noted that the Treasury Regulation restricts the credit to amounts *actually* set aside within the taxable year. Although such an interpretation is not binding on this Court, it is highly persuasive at least." (Emphasis the Court's.) (123 F. (2d) 274, 277.)

In view of the foregoing, we respectfully urge that there is no conflict between the *Strong* case and the *Antietam* case for the issue decided in the *Strong* case was never present in the *Antietam* case, since in the *Antietam* case there had been no actual setting aside within the tax-

able year as required by the statute and it therefore was no concern of the Fourth Circuit whether or not the statute makes it mandatory that the contract require *in terms* the setting aside within the taxable year. The expression of the Court in the *Strong* case that it did not reach the "same conclusion" as the Fourth Circuit in the *Antietam* case was accordingly dictum since under the facts the Fourth Circuit had no need in its disposition of the case to reach "a conclusion" on this point.

CONCLUSION.

In conclusion it is respectfully submitted that taxpayer is entitled to a credit of $20,949.30 in computing the surtax on its undistributed 1936 profits because:

(1) Taxpayer was under a fiduciary duty to irrevocably set aside such amount within the taxable year, as security for the debenture holders who had acquired an equitable lien enforceable in equity by specific performance; that by reason thereof taxpayer was required by written contract to irrevocably set aside such amount within the taxable year for the discharge of a debt incurred prior to April 30, 1936, said amount being 10% of its earnings and profits for such taxable year which had been so set aside and actually paid within the taxable year, and

(2) the legislative proceedings which eventually resulted in the enactment of Section 26 (c) (2) show an intent on the part of Congress to permit a credit in the instant case where an amount equal to a percentage of earnings and profits is required by written contract to be irrevocably set aside within the taxable year, although the time of payment is postponed until a date subsequent thereto when the amount of the percentage of such earnings can be definitely determined.

For the reasons above stated, we respectfully submit that the judgment of the Circuit Court of Appeals for the Sixth Circuit should be affirmed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends*—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of

the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written con-

tract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal

mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *



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In the Supreme Court of the United States

OCTOBER TERM, 1941.

No. ~~1017.~~ 41

GUY T. HELVERING,
Commissioner of Internal Revenue,
Petitioner,

vs.

THE STRONG MANUFACTURING COMPANY,
Respondent.

BRIEF OF THE STRONG MANUFACTURING COMPANY IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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March 27, 1942.

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In the Supreme Court of the United States

OCTOBER TERM, 1941.

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GUY T. HELVERING,
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THE STRONG MANUFACTURING COMPANY,
Respondent.

BRIEF OF THE STRONG MANUFACTURING COMPANY IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI.

I. INTRODUCTORY STATEMENT.

Respondent, The Strong Manufacturing Company, opposes the petition for certiorari filed in this Court by the Solicitor General on behalf of Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit entered in the above styled case December 9, 1941. Respondent, The Strong Manufacturing Company, will hereinafter be referred to as "Taxpayer." The Commissioner of Internal Revenue, Petitioner, will hereinafter be referred to as "the Commissioner."

II. OPINIONS OF UNITED STATES CIRCUIT COURT OF APPEALS AND BOARD OF TAX APPEALS.

The findings of fact, the majority opinion holding for Taxpayer and the minority opinion of the Board of Tax Appeals are reported in 41 B. T. A. 1273, and are also found in the Record, 14-22. The unanimous opinion of the Cir-

cuit Court of Appeals for the Sixth Circuit, affirming the decision of the United States Board of Tax Appeals for Taxpayer, is reported in 124 F. (2d) 360 and will also be found in the Record 134-141.

III. QUESTION INVOLVED.

Whether the United States Board of Tax Appeals and the United States Circuit Court of Appeals were correct in holding that Taxpayer was entitled to a credit on its 1936 surtax on undistributed profits under Section 26(c)(2) of the 1936 Revenue Act based on the irrevocable setting aside and payment of $46,500.00 of Taxpayer's 1936 profits on a note and mortgage executed April 15, 1932, which amount was less than the 40 per cent of its 1936 profits Taxpayer was expressly required, thereunder, to apply on said obligation.

IV. STATUTES AND REGULATIONS INVOLVED WILL BE FOUND IN THE APPENDIX ATTACHED TO THIS BRIEF.

V. INACCURACY IN COMMISSIONER'S STATEMENT OF FACTS CORRECTED.

The facts in this case as set forth in the Commissioner's "Statement" (Pet. for Cert., pp. 2-4) are substantially accurate according to Taxpayer's views, with the exception that the Commissioner interpreted Taxpayer's obligation to require only the excess over the specific installment due in each calendar year to be paid out of 40 per cent of such year's profits. Pet. for Cert., p. 3.

The Board of Tax Appeals by its findings of fact and opinion held *contra* to the interpretation of Taxpayer's note and mortgage contended for by the Commissioner, 41 B. T. A. 1273, R. 134-141. The Commissioner assigned

no error on this ground in the Circuit Court of Appeals and the Commissioner's argument on this point was overruled by the unanimous opinion of that court. R. 23-27, 134-141. 124 F. (2d) 360, 365. The Commissioner's interpretation of Taxpayer's note and mortgage, that only the excess above the specified installments due in 1936 were required to be paid out of 40 per cent of Taxpayer's 1936 earnings, is erroneous.

VI. POINTS ON WHICH TAXPAYER RELIES IN OPPOSITION TO THE COMMISSIONER'S PETITION FOR CERTIORARI.

(1) Upon the facts there is no conflict between the decisions of *Antietam Hotel Corp. v. Commissioner* (4th C. C. A., Nov. 10, 1941), 123 F. (2d) Sec. 274 and in *Commissioner v. The Strong Manufacturing Co.* (6th C. C. A., Dec. 9, 1941), 124 F. (2d) 360.

(2) The Federal Statute involved has been repealed and no like statute is now in effect, and, in any event, only an issue as to the interpretation of a contract unique in this case is presented.

(3) This case does not involve any important or far reaching issue of Federal law which this Court should determine.

(4) The Decisions of the United States Circuit Court of Appeals and of the United States Board of Tax Appeals are correct.

VII. REASONS WHY THIS COURT SHOULD NOT GRANT COMMISSIONER'S PETITION FOR CERTIORARI.

1. THE CONFLICT BETWEEN ANTIETAM HOTEL CORP. v. COMMISSIONER, 123 F. (2d) 274 AND COMMISSIONER v. THE STRONG MANUFACTURING CO., 124 F. (2d) 360, IF ANY, IS ONE OF FACT NOT OF LAW.

Taxpayer's note and mortgage in the case at bar, in terms, required it to "apply" 40 per cent of its annual net earnings in payment. Taxpayer's obligation to "apply" its profits connoted a requirement to irrevocably set aside for payment as well as pay such percentage of its net earnings on its note and mortgage. *Commissioner v. Strong*, 124 F. (2d) 360, 363, 365. Further, in the case at bar, the payment out of 40 per cent of Taxpayer's profits up to the balance due on its obligation was made by Taxpayer within the taxable year of 1936 (R. 44-45) constituting a definite act recognizing its creditor's equitable lien on such profits and a divesting of Taxpayer's control over them.

In the respect that Taxpayer's note and mortgage required the setting aside of profits during 1936 coupled with Taxpayer's definitive act of recognition of the equitable lien on these profits by paying them over to its creditor there is evidenced a complete compliance with Section 26(c)(2) of the 1936 Revenue Act as interpreted by the Court in *Antietam Hotel Corp. v. Commissioner*, 123 F. (2d) 274.

The contract in the *Antietam Hotel Corp.* case, *supra*, was essentially different than the note and mortgage in the case at bar. In the *Antietam* case, *supra*, the controlling provisions of the bond indenture did not require the debtor corporation to "pay" 60 per cent of its 1936 profits until March 20, 1942 and was wholly silent as to any obligation,—as is implicit in the use of the term "apply" in the note and mortgage in the case at bar,—to ir-

revocably set aside such profits as they accrued. Further in the *Antietam* case the debtor failed to segregate the profits applicable to the payment of the bonds prior to the end of 1936 or divest its control over them, as Taxpayer did in the *Strong* case, by paying over the obligated profits to the debtor in the taxable year. Because the facts in the case at bar do conform to the rule laid down in the *Antietam* case, the application of the rule in the *Antietam Hotel Corp.* case would not call for a different determination of the instant case. Contrary to the Commissioner's assertion, there is no discoverable conflict between the rules laid down in each case when applied to the facts in the case at bar. The Board of Tax Appeals in its Memorandum Decision handed down October 23, 1940, in the case of *Antietam Hotel Corporation vs. Commissioner*, C. C. H. B. T. A. Dec., Sec. 11357-A (affirmed by the Circuit Court of Appeals for the Fourth Circuit, 123 F. (2d) 274) distinguished that case from the *Strong Manufacturing* case, on the facts, as follows:

> "We have considered the general question involved in the instant proceedings in recent opinions. In *Strong Mfg. Co.*, 41 B. T. A. 1273, wherein the taxpayer was granted a credit, it appeared that the company anticipated its income for the taxable year and actually did make the payment within the taxable year there in question. Therein the facts differ materially from our instant case."

Commissioner's petition for certiorari should be denied since the conflict between the decisions in the *Antietam Hotel Corporation* case, *supra*, and *The Strong Manufacturing Company* case, *supra*, is one of facts and not of law. *Sanchez v. Borras* (1931) 283 U. S. 798, 51 S. Ct. 490, 75 L. Ed. 1421; *Wisconsin Elect. Co. v. Dumore Co.* (1931) 282 U. S. 813, 51 S. Ct. 214, 75 L. Ed. 728; *Layne and Bowler Corporation v. Western Well Works* (1923) 261 U. S. 387, 43 S. Ct. 422, 67 L. Ed. 712; *Keller v. Adams-Campbell Co.* (1924) 264 U. S. 314, 44 S. Ct. 356, 68 L. Ed. 705.

2. SECTION 26(c)(2) OF THE 1936 REVENUE ACT HAS BEEN REPEALED AND NO LIKE STATUTE IS NOW IN EFFECT OR LIKELY TO BE ENACTED.

There is no existing statute which needs to be interpreted or a similar statute to which such an interpretation might be applied by analogy. Section 26(c)(2) has been repealed after several amendments still proved the whole theory of the original law either impracticable or obsolete. 3 P.-H. Fed. Tax Serv. (1942) 50,241. Hence no great public interest requires this Court to take jurisdiction of this case.

3. THIS CASE DOES NOT INVOLVE ANY IMPORTANT OR FAR REACHING PRINCIPLE OF FEDERAL LAW WHICH THIS COURT SHOULD DETERMINE.

The case at bar presents, Taxpayer believes, only an issue as to the interpretation of apt language of a contract. The United States Board of Tax Appeals, by majority opinion, and the Circuit Court of Appeals for the Sixth Circuit, by unanimous affirmance, held Taxpayer's contract required the setting aside of a certain percentage of taxpayer's profits for the payment of a debt within the provisions of Sec. 26(c)(2) of the Internal Revenue Act for 1936. The Commissioner does not assert that the provision, here in issue, is typical of any contract involved in any other case under Section 26(c)(2). Moreover a diligent search by counsel does not disclose any case noted in the digests involving a contract of similar language. The Commissioner specifically admits that the contract in the case of *Guy T. Helvering, Commissioner v. Ohio Leather Co.*, No. 1016 pending on the docket of this Court by petition for certiorari, is not identical with the contract in the case at bar. Commissioner's Pet. for Cert., p. 4. The contract involved in the case of *Guy T. Helvering, Commissioner v. Warren Tool Company*, No. 1018 pending on the docket of this Court on petition for certiorari, is substantially similar to that involved in the *Ohio Leather*

Company case, *supra*, so that the Commissioner must concede that the contract in the *Warren Tool Company* case also differs from the contract in the case at bar. There is, therefore, involved in this case only a question of the interpretation of a unique contract which the Commissioner seeks to have redetermined after adverse decisions in both tribunals below. There is no issue present, as Taxpayer views it, of the interpretation of Section 26(c)(2). Taxpayer's Brief, Sec. VII, 1, *ante*. Moreover, the Commissioner in his brief opposing certiorari in the case of *Moloney Electric Company v. Commissioner*, Nos. 659 and 660 on this docket (certiorari denied Nov. 10, 1941, rehearing denied Jan. 12, 1942) asserted that the interpretation of Section 26(c)(2) of the 1936 Revenue Act, now repealed, was not necessary to the determination of future disputes. The Commissioner in his brief opposing certiorari in the *Moloney* case, *supra*, said in part:

> "The decision of the court below is correct in both cases and there is no conflict or other reason for review. Contrary to petitioner's assertion (Pet. 6), the cases do not present any important issue of Federal law which this Court should determine. They merely involve claims to credits in the computation of the surtax imposed by the Revenue Act of 1936 upon undistributed corporate profits, and their outcome turns, not on any new or far-reaching principle of law, but on the particular facts."

This Court had before it as a ground for granting reconsideration of its denial of certiorari in the *Moloney Electric Company* case, *supra*, the opinion of the Circuit Court of Appeals in the case at bar. Since the facts in the *Moloney Electric Company* case, *supra*, and in the *Antietam Hotel Corporation* cases are substantially alike and the decisions in both cases are adverse to the allowance of the claimed credit, the denial of certiorari in the *Moloney Electric Company* case is offered as specific authority against allowance of the writ in this case.

Commissioner's petition for certiorari should not be granted in this case since it will have no higher result than to allow him a third hearing on an issue determinative only of the instant controversy. *National Labor Relations Board v. Waterman S. S. Corp.* (1940) 309 U. S. 206, 60 S. Ct. 493, 84 L. Ed. 704; *Crowell v. Benson* (1932) 285 U. S. 22, 65, 52 S. Ct. 285, 76 L. Ed. 598; *United States v. Johnston* (1925) 268 U. S. 220, 45 S. Ct. 496, 69 L. Ed. 925; *Southern Power Co. v. North Carolina Service Co.* (1924) 263 U. S. 508, 44 S. Ct. 164, 68 L. Ed. 413; *Magnum Import Co. v. Coty* (1923) 262 U. S. 159, 163, 43 S. Ct. 531, 67 L. Ed. 922.

4. THE DECISIONS OF THE UNITED STATES CIRCUIT COURT OF APPEALS AND OF THE UNITED STATES BOARD OF TAX APPEALS ARE CORRECT.

It was established in the case at bar, without dispute by the Commissioner, that under his interpretation of Section 26(c)(2) all corporations who based their computation of profits in part upon an inventory would be unable to obtain a credit under that statute, for the reason that a physical inventory could not be taken until after the close of the calendar year. (R. 52-57, 134, 137.) Only financial institutions could qualify under the provisions of 26(c)(2) of the 1936 Revenue Act, and they were specifically exempt from the 1936 surtax on undistributed profits. U. S. Statutes at Large, 74th Congress, c. 690, Title I, Section 104(b), 49 Stat. 1677. The Court below held that no such construction of the statute was justified in view of the history of Section 26(c)(2) and the applicable rules of interpretation set forth in the decisions of this Court which it cited. *Commissioner v. The Strong Manufacturing Co.*, 124 F. (2d) 360, 363-364. This Court has held that Section 26(c) comprehends a computation based on an entire year's corporate profits. *Helvering v. Northwestern Steel Mills* (1940) 311 U. S. 46, 61 S. Ct. 109. Since no such computation could be made until after the close of the year, that undoubtedly correct conclusion is additional support for

the decisions of the United States Board of Tax Appeals and of the Circuit Court of Appeals below in the case at bar. The decision of the United States Circuit Court of Appeals for the Sixth Circuit and of the United States Board of Tax Appeals in the case at bar are supported by such sound reasons and in accord with principles the United States Supreme Court has so many times affirmed that it should not take jurisdiction on the Commissioner's petition for certiorari.

VIII. CONCLUSION.

In conclusion, Taxpayer submits, that the conflict claimed by the Commissioner to exist between the decisions of *Antietam Hotel Corporation v. Commissioner*, 123 F. (2d) 274 and *Commissioner v. The Strong Manufacturing Company*, 124 F. (2d) 360, is solely one of fact. Section 26(c)(2) of the 1936 Internal Revenue Act, here involved, has been repealed and no like statute is now in effect demanding an interpretation by this Court. Moreover, this case raises only an issue as to the interpretation of Taxpayer's contract and no purpose can be served if this Court takes jurisdiction except to grant the Commissioner a third hearing after an adverse result in both tribunals below, which decisions are sound and in accord with principles repeatedly affirmed by this Court. It is, therefore, urged that this Court should not grant the Commissioner's petition for certiorari in this cause.

Respectfully submitted,

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March 27, 1942.

APPENDIX.

Revenue Act of 1936, Statutes at Large, c. 690; 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—(1) The term "adjusted net income" means the net income minus the sum of—

(A) The Normal tax imposed by section 13.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26(c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

* * * * *

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends.*—

* * * * *

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior

to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—

(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of Section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of

the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such funds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

* * * * *

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 41.

GUY T. HELVERING,
COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

THE STRONG MANUFACTURING COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF THE STRONG MANUFACTURING COMPANY, RESPONDENT.

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ERRATA.

The Circuit Court opinion in the instant case is erroneously set forth on pages 1 and 69 herein as being reported at 124 F. (2d) 397. The correct citation is 124 F. (2d) 360.

The related *Ohio Leather* and *Warren Tool* cases are reported at 124 F. (2d) 397.

The Findings of Fact and Opinions of the U. S. Board of Tax Appeals (41 B. T. A. 1273), referred to on page 1 herein as "Appendix A," should have been referred to as "Appendix B."

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 41.

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ON WRIT OF CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF THE STRONG MANUFACTURING COMPANY, RESPONDENT.

I. NATURE OF THE CONTROVERSY.

This cause comes before this Court at the instance of the Commissioner of Internal Revenue, after his petition for a writ of certiorari from the decision of the United States Circuit Court of Appeals for the Sixth Circuit was allowed. The opinion of the United States Circuit Court of Appeals is printed in "Appendix A" of Respondent's Brief and is reported in 124 F. (2d) 397. The Findings of Fact and Majority and Minority Opinions of the United States Board of Tax Appeals (41 B. T. A. 1273) are attached to Respondent's Brief as "Appendix A."

The Circuit Court of Appeals and Board of Tax Appeals held that The Strong Manufacturing Company was entitled to a credit under Section 26 (c)(2) of the Revenue Act of 1936 by reason of the payment of $46,500.00 of its profits pursuant to a note and mortgage, executed prior to May 1, 1936. It was further held that said contract required the "application" of said amount of the earnings "as of" the taxable year 1936, or its irrevocable setting aside as contemplated by the statute. The Commissioner of Internal Revenue here disputes the correctness of the decisions of the Circuit Court of Appeals and of the Board of Tax Appeals.

The Strong Manufacturing Company will hereinafter be referred to as "the Taxpayer." The Commissioner of Internal Revenue will hereinafter be referred to as "the Commissioner." Italics used in the brief are ours, unless otherwise noted.

At the request of the Solicitor General Taxpayer stipulated that certain portions of the record before this Court should not be printed, without prejudice, however, to the right of either party to refer, in oral and written argument, to any portion of such record whether or not printed. All Taxpayer's references to unprinted portions of the record will be designated "OR." All Taxpayer's references to parts of the printed record lodged in this Court will be identified as "PR."

Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

II. QUESTION PRESENTED.

Is the Taxpayer entitled to a credit on its 1936 surtax on undistributed profits under Section 26 (c)(2) of the 1936 Revenue Act, based on the payment of $46,500.00 of Taxpayer's 1936 profits on a note and mortgage executed

by it April 15, 1932, which required Taxpayer to apply forty per cent. (40%) of the 1936 profits of Taxpayer in retirement of said obligation?*

III. STATUTES AND REGULATIONS INVOLVED.

(1) Statutes.

Taxpayer's claim to a credit in this case, which was unanimously affirmed by the United States Circuit Court of Appeals and the Board of Tax Appeals, is governed by the following statutes:

Section 14 of the Revenue Act of 1936:

"Sec. 14. *Surtax on Undistributed Profits.*

(a) Definitions.—As used in this title—

• • •

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

• • •

(June 22, 1936, 9:00 P. M., c. 690, Title I, Section 14, 49 Stat. 1665; Aug. 26, 1937, 10:00 A. M., c. 815, Title IA, Section 2, 50 Stat. . . . .)" 6 F. C. A. (1937) 21.

Section 26 of the 1936 Revenue Act, under which Taxpayer claims a credit:

"Section 26. CREDITS OF CORPORATIONS.—In case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

• • •

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*By reason of the stipulation between the Taxpayer and Commissioner, settling the matter of allowable deductions for repair and replacement expense claimed by Taxpayer in its 1936 income tax return and the decision of the Board of Tax Appeals confirming said compromise, that issue is removed from the case. OR. 23, 32-33.

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.

• • •

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR. An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936.

• • •

(June 22, 1936, 9:00 P. M., c. 690, Title 1, Section 26, 49 Stat. 1664.)" 6 F. C. A. (1937) 50-51.

(2) Regulations of Bureau of Internal Revenue under Revenue Act of 1936.

Regulations of the Bureau of Internal Revenue under the Revenue Act of 1936, pertinent to the question here presented, are:

"ART. 26-2. CREDIT IN CONNECTION WITH CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—(a) The credit provided in section 26(c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. • • • The provisions recognized by the Act are of two general types, as follows:

• • •

(2) Those which come within section 26(c)(2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * *

(c) Disposition of profits of taxable year.—Under the provisions of Section 26(c)(2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c)(2) * * *. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of 'net income,' 'net earnings,' or 'net profits.'"

(Regulations 94 of Bureau of Internal Revenue under Revenue Act of 1936, 120-121, 123.)

IV. STATEMENT OF FACTS.

The Taxpayer is an Ohio corporation in the Village of Sebring, Mahoning County, Ohio, organized in 1932 for the purpose of manufacturing enamelware. OR. 36-37, Ex. 1, OR. 67. Taxpayer purchased its entire plant and equipment from the Central United National Bank, Cleveland, Ohio, Trustee for the bondholders of the Sebring Manufacturing Company, about April 15, 1932, for the sum of $50,-

000.00. OR. 35-37. The entire purchase price was evidenced by a note secured by a mortgage executed to the Central United National Bank (hereinafter referred to as "the Bank"). OR. 37-38. The note reads as follows:

"For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941

Any unpaid portion of the said principal sum shall bear interest from April 15, 1932, at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January

1, 1934 upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof."—Ex. 2, PR. 26-27.

The chief provisions of the underlying mortgage (Ex. 3, PR. 28-40) pertaining to this controversy are as follows:

"ARTICLE I.

Anticipation of Payments upon Note.

(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term 'net earnings' as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured remain unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment, be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note;

* * * * *

ARTICLE IV.

Remedies on Default.

(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1, hereof, and such default shall have continued for thirty (30) days; * * * the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued

thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. * * *

(2) No waiver by the Bank of any such default by the Company whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom."

The provisions of the note respecting the application of forty per cent. (40%) of Taxpayer's net earnings of each year on the note and the like provisions found in Article I, Paragraph (1) of the mortgage (PR. 31-32) were inserted by the Bank to insure that in prosperous years Taxpayer would devote a substantial portion of its profits to the retirement of the note and mortgage and, to that extent, anticipate and protect the Bank against inability of the Taxpayer to pay the obligation in lean years. OR. 38.

In 1934 Taxpayer was handicapped by lack of working capital and obtained from the Bank a written extension on a then due installment of $2,000.00 principal and $3,500.00 interest on said note and mortgage. OR. 40, Ex. 4, OR. 102. The extension agreement was specifically conditioned that "such extension shall not be construed as a waiver of any subsequent defaults." Ex. 4, OR. 102-103. See also Ex. 3, Art. IV, Par. 2, PR. 36. However, the Bank never waived or made any concession whatsoever in respect to the covenants of the note and mortgage requiring Tavpayer to apply forty per cent. (40%) of its net earnings in payment thereof. OR. 48, 51-52.

Taxpayer's estimated profits on September 30, 1936, were $86,000.00, and at that time it had unfilled orders on its books approximating the amount of $100,000.00. OR. 44, 46. Taxpayer's net income for the year 1936, as reported in its income and excess profits tax return for that year, was $126,786.04. Ex. 1, OR. 67. On January 1, 1936, the balance due from the Taxpayer on said note and mort-

gage was $47,000.00. OR. 39. Said amount was less than forty per cent. (40%) of its profits for the year 1936. During 1936 the Taxpayer made payments out of profits on the principal of its note and mortgage, exclusive of interest,* on the dates and in the amounts as follows:

2/15/36	$2,500	7/31/36	$ 1,000
4/15/36	2,500	8/14/36	500
5/15/36	500	8/31/36	2,000
5/29/36	1,000	9/15/36	500
6/15/36	500	10/15/36	34,000
6/29/36	1,000		
7/14/36	500	Total	$46,500

OR. 39, 44-45, 47; PR. 54. Ex. 5, OR. 107-129.

The Bank waived payment of principal in the sum of $500.00 and interest of $117.50 and accepted $46,500.00 in full of the balance due on the note and mortgage. OR. 39, 46-47, 48.

Because of the fact that the Taxpayer is a fabricator of raw materials and the computation of its profits is based, in part, on a physical inventory of its raw materials, materials in process, and finished goods, it was an impossibility for it to accurately determine its profits for the year 1936 on December 31, 1936. PR. 24. Taxpayer filed its 1936 income tax return on the accrual basis. Ex. 1, OR. 71. Taxpayer's admitted income and excess profits tax liability for the year 1936 is $29,136.99, constituted as follows:

Total normal income tax returned for 1936 (Ex. 1, OR. 65)	$17,616.83
Additional normal tax liability, arising from compromise of disputed deductions for repair and replacement expense, confirmed by the decision of the Board of Tax Appeals, returned for 1936 (PR. 16-17; OR. 32-33)	$ 2,133.63

* Payments of interest made by the Taxpayer on the note and mortgage in 1936 are not material to the controversy and reference to them is omitted. OR. 39.

Surtax on undistributed profits returned for 1936 (Ex. 1, R. 65)	$ 7,358.97
Excess profits tax return by Taxpayer for 1936 (Ex. 1, R. 65)	$ 1,607.16
Additional excess profits tax, through compromise of disputed items of repair and replacement expense, confirmed by the Board of Tax Appeals in its decision (PR. 16-17; OR. 32-33)	$ 420.40
TOTAL	$29,136.99

The deficiency surtax assessed by the Commissioner upon the alleged undistributed profits of Taxpayer for 1936, but disallowed by the Board of Tax Appeals in this case, is $14,776.89, less the proper reduction of that amount to reflect the adjustments agreed upon by the parties at the hearing before the Board of Tax Appeals.

V. FACTS DISTINGUISHING STRONG CASE FROM OHIO AND WARREN CASES.

The facts in the Strong case and the companion Ohio and Warren cases (Oct. Term 1942, Nos. 40 and 42) are substantially distinguishable only, in that under the Strong note and mortgage payment due could only be made in cash. In the Ohio and Warren cases the taxpayers had the option of paying in cash or depositing debentures or bonds issued under the respective indentures. Neither the Board of Tax Appeals nor Circuit Court of Appeals considered this difference of fact material. The Commissioner has not and does not now seek to differentiate his contentions based on any such distinction in facts. Hence the point will be passed without further discussion.

VI. SUMMARY OF ARGUMENT.

It is the view of the Commissioner that Taxpayer's note and mortgage fail to comply with Section 26 (c)(2) of the 1936 Revenue Act because it did not require forty per cent. (40%) of Taxpayer's 1936 profits paid thereon within that taxable year *in terms, expressly* [redacted] to be irrevocably set aside for that purpose. The decisions of the United States Circuit Court of Appeals and of the Board of Tax Appeals unanimously held that the Taxpayer's contract required the irrevocable setting aside of 40% of the Taxpayer's profits "as of" the taxable year 1936, and fully complied with the requirements of that section. PR. 14-15, 48. Commissioner admits that under his interpretation, Section 26 (c)(2), in fact, affords no relief. Commissioner's Brief, 20, footnote. The Taxpayer's interpretation of Section 26 (c)(2) follows the clear intent of Congress and the language of the statute.

VII. ARGUMENT.

A. Argument on Facts.

1. A CONTRACT CONFORMING TO THE COMMISSIONER'S INTERPRETATION OF SECTION 26 (c)(2) WOULD BE IMPOSSIBLE OF PERFORMANCE BY TAXPAYER AND ALL CORPORATIONS REQUIRED TO TAKE A PHYSICAL INVENTORY TO DETERMINE ANNUAL PROFITS.

The Taxpayer here involved is a typical corporation engaged in the manufacturing of raw material into finished products. We are persuaded that it becomes necessary, in any extended study of the application of Section 26 (c)(2) of the 1936 Revenue Act to corporations, to make due allowance for the wide differences in the practical situation where a corporation such as a bank* is involved and where

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* It is noteworthy that banks and trust companies who could perform a contract conforming to Section 26 (c)(2) of the 1936 Internal Revenue Act, as interpreted by the Commissioner, were wholly exempt from the 1936 surtax on undistributed profits. c. 690, Title I, Section 104, 49 Stat. 1677; 6 F. C. A. 77, Section 107 (Section 104) (b).

a corporation fabricating finished products from raw materials is involved. A bank deals in cash or in evidences of indebtedness whose realizable value is quite readily ascertainable. A bank does not produce, but returns its earnings by making loans or by the value of the use of its money. In a bank the value of money, of course, fluctuates, but ordinarily in a readily ascertainable degree. Money, or assets readily converted into money, are its chief assets. The future value of the assets of a bank also can be determined with a fair degree of accuracy by persons familiar with the surrounding conditions. The inventory of the assets of a bank, and economic forces affecting those assets, are subject to standards permanent enough and easily enough ascertainable to be dealt with quickly.

The case of the assets of a manufacturing corporation are entirely different. The assets are large in number, with varying lives, in varying degrees of fabrication, and with varying values. As an example, Taxpayer manufactures over two hundred different enamelware products with many variations of those products, with degrees of such manufacture constantly varying from the raw material to the finished product, and with values from a few cents to hundreds of dollars. They present a problem of a multiplicity of more or less minute units constantly shifting and ever-changing. Obviously the practical determination of profits in the latter case differs greatly from the determination in the former case. We are here dealing with a corporation manufacturing raw materials, namely, enamelware, in many different forms and we deem it material that this fact be kept constantly in mind.

The Commissioner would have this Court believe that Congress intended, in enacting Section 26 (c)(2), that a contract, to comply with its requirements, would demand the ascertainment of the profits of the subject corporation on December 31, 1936, and the payment of the required percentage of its profits on the indebtedness evidenced by that contract. Such a condition would be impossible of perform-

ance by the Taxpayer and by the majority of corporations to which Section 26 (c)(2) was meant to apply. As we have shown, only a bank or a corporation dealing in a like commodity whose value was constant and easily ascertainable from day to day could conform itself to the rigorous and impracticable demands of Section 26 (c)(2) as interpreted by the Commissioner. This is borne out by the evidence in this case.

Taxpayer's auditors, Messrs. Clark and Collins, a firm of Certified Public Accountants, who prepared the Federal Income Tax Return in this case and participated in the representation of the Taxpayer in this controversy before the Collector of Internal Revenue and before the Board of Tax Appeals, has offices in the cities of Cleveland, Youngstown, Canton, and Warren, Ohio, and has some two hundred active clients, representing a cross-section of the industrial corporations in northeastern Ohio. PR. 22-25. A member of that firm, Sidney J. Collins, also a Certified Public Accountant, engaged in accountancy since 1921 and presently a member of the Ohio State Board of Accountants, testified that neither the Taxpayer nor any industrial corporation could determine its profits for the past year on December 31st. PR. 22-26. Mr. Collins' testimony is as follows (PR. 24):

> "Q. Would it have been possible to determine the exact earnings of the Strong Manufacturing Company as of December 31, 1936, for the preceding taxable year on January 1st? I mean, would it have been physically possible?
>
> A. No. The whole structure of accounting is based (on the condition of the company) at the close of the year, December 31st, at midnight. The books must yet be closed, inventories must be checked. Proper recognition of that is given by the income tax requirement that tax return be filed two and a half months following the close of the year. So it is actually impossible to determine the exact profits in the calendar year as of December 31st in that year.

Q. And this applies to the Strong Manufacturing Company?

A. Yes. And in the study of the law under 26C-2 we had to—

Mr. Pierson: Now, if Your Honor please—

A. We had—I am going to state what we told the company.

Mr. Pierson: All right.

A. We instructed or notified this company that the construction of that law was our opinion,—rather, our opinion was that the construction of 26C-2 was that they must pay or irrevocably set aside forty per cent of the profits in the year, 1936. We did explain to them, upon their request, as to this payment, it would be physically impossible for them to be sure of profits until after the books were closed. We, therefore, put our own construction on this contract that the law, including irrevocably setting aside, was taking care of that contingency where the company was not sure as of December 31st that the profits would be sufficient to require the payment of forty per cent." (Parenthetical matters ours.)

The Witness, Collins, further testified on page 25 (PR):

"By Mr. Powers:

Q. First, Mr. Collins, I will ask you how long have you been in the accounting business?

A. Since I came back from France, 1919.

Q. Over that period of time, what has been your experience?

A. I have served as an instructor in accountancy in the university, been actually engaged in accounting since 1921 in public practice. During that time I have appeared before the Board of Tax Appeals on income tax many times.

Q. How many companies have you prepared income tax returns for?

A. It would be rather difficult, Mr. Powers, but we have some two hundred active clients at the present time.

Q. Are they conducting one type of business, or are they diversified?

A. All kinds.

Q. Would you consider they represent a cross section of industrial activity in this vicinity?

A. I do.

Q. I will ask you, Mr. Collins, if any of those corporations could accurately determine their profits on December 31st of the year in which those profits are earned?

A. It would be physically impossible to determine the actual profits of the calendar year as of the last day.

Q. Of any of the corporations you represent?

A. Any corporations, with one exception of the bank, which, as of the close of the next day, there is a trial balance which does show the profits as of that year.

Q. How about industrial corporations?

A. Industrial corporations, no. I might add, any corporation that has a physical inventory on which it bases its profits, could not take that inventory until the close of the year. If they did, they would be subject to penalty from the income tax department for not having the correct inventories.

Q. And therefore, if a contract or a mortgage obligation provided for the application of a certain percentage of profits payable in the year in which the profits were earned, it would be impossible for a corporation to comply with those conditions?

Mr. Pierson: I object to that, Your Honor.

A. Absolutely.

Mr. Pierson: Just a moment. I object to that, Your Honor.

The Member: I will take it for what it is worth. Overrule the objection.

Mr. Pierson: No questions."

We will hereafter show that Congress had manufacturing concerns such as Taxpayer specifically in mind and must have selected the terms used in Section 26 (c)(2) with

care to cover such contracts as the Taxpayer's. It is hardly necessary here to indulge in further demonstration that the Commissioner's view is not in accord with the practical exigencies of an accurate determination of Taxpayer's profits. On the contrary, the interpretation of Section 26 (c)(2), adopted by the United States Circuit Court of Appeals and the Board of Tax Appeals in their decisions, is not only practical but does no violence to the statutory language.

2. THE NOTE AND MORTGAGE BEFORE THE COURT IN TERMS REQUIRED THE PAYMENT OF ALL AMOUNTS CONSTITUTING THE BALANCE DUE ON JANUARY 1, 1936, OUT OF TAXPAYER'S PROFITS IN THAT YEAR.

The Commissioner takes the further view,—which the Circuit Court overruled in its opinion (PR. 48-49)—that the note and mortgage in issue required a minimum payment of $5,000.00, in any event, and that Taxpayer was not required to make that payment out of its 1936 profits, even though 40% of Taxpayer's 1936 profits were sufficient to cover that as well as all other payments due in 1936. Commissioner's Brief 6, 15-16. On the contrary, Taxpayer contends that the literal terms of the note and mortgage in issue permitted the payment of the minimum installment of $5,000.00 due in 1936, in any event, or permitted such part of it to be paid out of other funds of the Taxpayer, only if and only to the extent that 40% of Taxpayer's 1936 profits would not satisfy it. First, however, Taxpayer wishes to show that the provisions of Taxpayer's note and mortgage pledging a substantial portion of its earnings were not casually inserted as a make-weight.

The bondholders, whom the Bank, as mortgagee, represented, had seen the predecessors of the Taxpayer go through the prosperous times of 1925 to 1929 without paying their bonds. Instead, when the crash came, the bondholders' debtor went into bankruptcy and the bondholders

were forced to become the owners of an idle enamelware plant. Profiting by their past experience, the bondholders insisted, in dealing with Taxpayer, on participating in its profits,—in addition to all other security provided by the note and mortgage for the payment of the indebtedness. Anthony Poss, Corporate Trust Officer of the Bank, OR. 36, 38-39. The undisputed testimony of Mr. Poss,—far from giving any support to the Commissioner's contention that the terms of the note requiring payment in specified installments were the most important,—shows that the terms of the note and mortgage requiring the application of profits on the indebtedness were paramount in the mind of the Bank. Mr. Poss testified on direct examination, as follows (OR. 38):

"By Mr. Powers:

Q. Are you familiar with the provisions in the note and mortgage concerning the application on these obligations of the profits, earnings of the Strong Manufacturing Company?

A. I am.

Q. Will you state to the Court, if you know, how this provision happened to be put in these instruments, and who required it?

A. It was required on the part of the Central National Bank, as trustee, and they were certified because of the fact that the Strong Manufacturing Company was given, independent of the property, a mortgage representing the entire purchase price, and the representative of the bank, as trustee, felt in that event, should the company be prosperous for a few years, a portion of their profits should be devoted to the payment of this mortgage, so that we would not come to the point, five or six years hence, where the mortgage might be half paid off and the company become involved in difficulties and perhaps have the profits go out in dividends, and the Bank, as trustee, have the property back in its hands."

As further evidence of how seriously the Bank followed the performance of Taxpayer in this regard, it will be noted

that *quarterly* statements of earnings of Taxpayer were required in said mortgage to be furnished to the Bank—and they were, in fact, furnished. Ex. 3, Art. I(2), PR. 32; OR. 39.

The note in issue (Ex. 2) does call for a minimum installment of $5,000.00 on April 15, 1936, but *further* requires that such payment shall be made only out of 40% of Taxpayer's 1936 profits, if they are, and to the extent, so much of such profits are sufficient. Reference is made to said note (Ex. 2), para. 4, reading:

> "As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, *provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year,* all as more fully set forth in said mortgage deed." Ex. 2, OR. 86.

The word "amount" in the italicized language clearly refers to the 40% of the Taxpayer's profits and the whole clause should be interpreted to read—provided that the amount "of Taxpayer's net earnings" so applied on the note shall never be less than the minimum installment stated in dollars. This clause emphasizes that the Bank considered the provisions of the note as to the application of the stipulated percentage of profits of equal or more importance than the provisions requiring minimum annual dollar payments. The Bank, no doubt, also inserted this clause to take care of a situation where, say, 40% of Taxpayer's annual profits amounted to $3,000.00 and the minimum dollars payment in that year called for $5,000.00. In that event, Taxpayer would be required to pay $5,000.00 from its profits for that year—regardless of what percentage that amount was of the total annual profits. But it

is clear that only if the annual profits of Taxpayer were insufficient to satisfy the stipulated minimum installment that Taxpayer could pay all or a part thereof out of funds other than its profits for that year.

The note represents the principal obligation of the Taxpayer and its terms are controlling. However, like reference can be made to the mortgage securing the note for confirmance of the contentions of the Taxpayer. Article I, Section 1 of the mortgage, Ex. 3, PR. 31-32, reads as follows:

> "The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred and thirty-four, the Company will apply forty percentum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment *by the terms of said note* nor of the regular interest payments in such year, likewise as specified in said note. * * *"

The reference here made to the payments required "by the terms of said note" incorporates in the mortgage by reference not only the terms thereof in respect to specific dollar payments but also the terms defining the source out of Taxpayer's funds from which such payments were obligated to be made.

The obligation to make all 1936 payments on the note and mortgage out of its profits for that year was so interpreted by the Taxpayer's Auditors, its counsel, and the Taxpayer's officials, and the uncontradicted evidence in this case shows that all payments thereon in 1936 were, in fact, made out of the profits of the Taxpayer. OR. 44-45, 51, PR. 24-25.

The Taxpayer, therefore, submits that the decision of the court below was utterly correct in holding that Taxpayer's note and mortgage required it to irrevocably set aside $46,500.00 of its 1936 profits within the terms of Section 26 (c)(2) for the payment of said indebtedness,—of which amount $5,000.00 was paid on or before April 15, 1936, and the balance of $41,500.00 was paid on or before Oct. 15, 1936.

B. Argument on the Law.

1. CONGRESS CLEARLY INTENDED THAT SECTION 26 (c)(2) OF THE 1936 REVENUE ACT SHOULD GRANT A DEDUCTION AS TO PROFITS APPLIED UNDER CONTRACTS CONTAINING PROVISIONS IDENTICAL WITH THAT IN ISSUE IN THIS CASE.

The Commissioner further seeks to establish, in substance, that the legislative history of Section 26 (c)(2) shows that only contracts in terms requiring payment or irrevocable setting aside of profits would entitle the affected taxpayers to credits. Obviously, there is no language to that effect in the statute. Moreover, the legislative history of the section—that cited by the Commissioner and that hereafter referred to by Taxpayer—wholly supports the decisions of the tribunals below.

The surtax on undistributed profits was originally inspired by the message from the President to Congress, dated March 3, 1936. The President's message read, in part, as follows (Hearings before the Ways and Means Committee, pages 2-3):

> "I invite your attention, however, to a form of tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop 'leaks' in present surtaxes.
>
> • • •
>
> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged

by the present freedom of undistributed corporate income from surtaxes. * * *"

It will be conceded that the purpose of the act, as stated in the President's message, was fully intended by Congress to be carried out, in the 1936 Revenue Act. As stated in *Paul and Mertens Law of Federal Income Taxation*, 1939 Cumulative Supplement, page 1390, Section 32A.01:

> "An additional factor entering into the legislative purpose in the enactment of the undistributed profits surtax was the belief that the tax would be of economic benefit in increasing the velocity of the monetary circulation and maintaining purchasing power by the distribution of money to stockholders.
>
> The general basic purpose of the undistributed profits surtax may be said to provide a system of taxation which, so far as possible, would 'in effect treat the corporation as a "conduit to income."' "

And another authority has said:

> "Even if the denomination by Congress of the tax as a 'Surtax on Undistributed Profits' be disregarded, the purpose of Congress was, clearly, to force the distribution of profits, and for all practical purposes the tax is imposed on the *undistributed* portion of the profits." *Homer Hendricks "The Surtax On Undistributed Profits of Corporations."* 46 *Yale Law Journal*, 19, at page 48.

It follows conversely that it was not the thought of proponents of the tax, or of Congress,—within the limits of Section 26 (c) of the 1936 Revenue Act, *liberally construed*, —to impose the surtax on profits which were distributed or set aside, for payment on corporate indebtedness. This collateral, but equally controlling, purpose to grant relief in such instances is disclosed in the Report of the Sub-Committee of March 26, 1936, to the House Ways and Means Committee, recommending that corporate profits

obligated to discharge indebtedness be taxed at a flat rate.* Section XX of the Report of the House Sub-Committee reads, in part, as follows:

> "It is recommended that a corporation which has, prior to January 1, 1936, made a bona fide contract not to pay dividends, *or not to pay out as dividends a stipulated portion of its earnings and profits for the taxable year*, shall be taxed 22½% on the part of the adjusted net income which equals the earnings and profits which it is prohibited by the contract from using for the payment of dividends." Hearings before the House Ways and Means Committee, page 10.

Repeated references to this provision were made by members of the House Ways and Means Committee during the hearing and numerous protests were made by witnesses appearing before the Committee against any surtax whatever being imposed on such disposition of profits. House Ways and Means Committee Hearings, pages 63, 129, 177, 235, 278, 286, 315, 404, 406, 484, 567, 836. Special reference was made by many of the witnesses before the House Ways and Means Committee to mortgages containing clauses similar to that under consideration in this case. The Taxpayer particularly wishes to make reference to the statements of E. C. Alvord (House Ways and Means Committee Hearings, pages 803 to 841), formerly connected with the Treasury Department, who appeared on behalf of the United States Chamber of Commerce, and whose testimony and criticisms were evidently listened to with great interest. Mr. Alvord states (House Ways and Means Committee Hearings, pages 836-837) in his written statement filed with the Committee:

> "Corporations may be grouped into three classes, from a point of view of dividend-paying ability:
>
> * * *

---

* Taxpayer has already paid a 1936 normal income tax and an excess profits tax on the amount in controversy. Ex. 1, OR. 65.

(2) Corporations prohibited by contract from declaring dividends, for example, by a clause in a *mortgage indenture* that a specified portion of the annual earnings and profits must be set aside to retire the indebtedness; • • •

Let us now examine the application of the proposal:

• • •

"(5) The corporation with a contract obligation will likewise be less favorably situated than a corporation privileged to pay dividends."

Mr. Alvord, in this statement, was protesting against Article XX of the Sub-Committee Report, quoted above, in respect to the tax of 22½% upon that portion of corporate profits required, by contract, to be set aside or paid on corporate debts. As a result of the protests before the Ways and Means Committee, the House Bill was even more liberal than the Bill as finally enacted in the matter of relieving undistributed profits from the surtax. The House Bill relieved all earnings where used to make up deficits from a surtax and applied a flat rate of 22½%. House Bill, Section 14. Section 15 provided similar relief as to profits which could not be paid out in dividends without violating a written contract in existence prior to March 3, 1936. Section 16 of the original House Act was equally liberal, in principle, in the case of certain debts in excess of the accumulated earnings and profits. See *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1392, Note 28.

The effect of the House Bill, in the opinion of the Ways and Means Committee, was summarized as follows:

"This new plan of taxing corporate net income, in the opinion of your Committee, will not prevent the retention of earnings *sufficient to provide for legitimate corporate needs* but will discourage accumulation for which there is no sound reason." Ways and Means Committee Report No. 2475, 74th Cong., 2nd Sess., p.

8. *Paul and Mertens Law of Federal Income Taxation,* 1939 Supplement, 1392.

And as stated by Mr. Samuel B. Hill on the floor of the House (*Paul and Mertens Law of Federal Income Taxation,* 1939 Supplement, 1392, Note 28):

> "Now, that takes care of section 16 which we had not yet reached, but I am now going to call attention to section 15, which deals with contracts not to pay dividends. If a corporation as of March 3, 1936, finds itself in a position, by reason of a contract entered into with its creditors, not to pay dividends until it has paid its creditor his debt or has established a sinking fund, *or otherwise provided means of paying the obligation,* if it is under that handicap by reason of a written contract, then we allow the corporation a 22½ percent flat rate on that portion of the net income which it is unable to pay out, by reason of this contract, in dividends. Then you get a new base for the tax on the remainder under the general plan. Congressional Record—House, Vol. 80, No. 84, p. 6196, April 23, 1936."

And in the opinion of eminent tax authorities:

> "The House Bill provided for certain exceptional cases involving corporations which could not pay out dividends, or where 'sound policy' demanded the non-payment of dividends." *Paul and Mertens Law of Federal Income Taxation,* 1939 Supp. 1391-1392.

The House Bill, then, gave corporations relief from surtax where deficits existed, where certain types of indebtedness exceeded corporate surplus and accrued earnings and as to contracts preventing the payment of dividends. This is a compelling guide as to the liberal application Section 26 (c)(2) of the 1936 Revenue Act should be given, to Taxpayer's note and mortgage, for:

> "The spirit of this House Bill dominated the final Bill enacted (Section 26(c) of the 1936 Internal Revenue Act), but inasmuch as so many detailed changes were made *the original Bill is important as indicating*

the basic legislative intent underlying the new act." *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1392. (Parenthetical matter ours.)

Important discussion of what was finally Section 26 (c) of the 1936 Revenue Act, and its application, was also had on the floors of the House and Senate, with the purpose of enlarging its scope. *Congressional Record—House*, Vol. 80, No. 86, p. 6451; *Congressional Record—Senate*, Vol. 80, No. 116, p. 9193.

Protests were renewed against the levying of any surtax in respect to corporate profits, required by contract to be devoted to the discharge of indebtedness, by witnesses before the Senate Committee on Finance, considering the 1936 Revenue Act. These protests received sympathetic response from the members of that Committee. Extended reference to the discussions that took place before the Senate Finance Committee would be redundant of what the Taxpayer has shown took place before the Ways and Means Committee. See Report of Hearings before the Senate Committee on Finance on H. R. 12395 (Revenue Act. 1936), pp. 107, 117, 316, 318, and 643. In general, the Bill was subject to more violent criticism in the Senate than when before the House. *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1393-1396, Section 32A.03. This undoubtedly brought about the complete relief from all surtax of corporate earnings devoted to the discharge of indebtedness under the obligations of a written contract.

When the House Bill reached the Senate, Sections 15 and 16 were combined as subdivisions 26 (c)(1) and 26 (c)(2), respectively, of the Senate Bill. Section 26 of the Senate Bill was modified in conference but the language of 26 (c)(1) of the Senate Bill was retained intact and became subdivision 26 (c)(1) of the 1936 Revenue Act. *Paul and Mertens Law of Federal Income Taxation*, 1939 Supplement, 1392, Note 28.

As further indicating the liberal construction intended by Congress, as opposed to a technical application of the language used in the statute, it is to be noted that Section 26 (c)(2) contains the following liberalizing provision:

> "For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits." June 22, 1936, 9:00 P. M., c. 690, Title I, Section 26, 49 Stat. 1664, 6 F. C. A., 50, Title 26, Section 26 (c)(2).

The Commissioner, in that portion of his brief dealing with the legislative history of Section 26 (c)(2), undoubtedly demonstrates that Section 26 (c)(2) was intended to apply to contracts, only, which required that earnings must be paid or irrevocably set aside during the taxable year. The Commissioner falls into grievous error in drawing the conclusion that Section 26 (c)(2) should be interpreted to provide contracts must "expressly" or "in terms" set forth that earnings must be irrevocably set aside during the taxable year since the statute itself does not so state. Rather it is more logical to infer that the sponsors of the more liberal provision, qualifying contracts requiring payment in the "dividend" year accepted the compromise provision for payment or *irrevocable setting aside* of profits within the taxable year—not necessarily by express terms of a contract but also by implication. Surely, if the legislature intended a niggardly relief to the few fortunate corporations whose contracts, obligating profits to discharge indebtedness, contained the exact applicable language of Section 26 (c), this provision above-quoted would not have been inserted. Of course, the fact that Section 26 (c) applies only to contracts entered into *before* its enactment,—May 1, 1936,—leads to the conclusion that Congress intended that Section 26 (c) should apply to a class of contracts expressing the substance of the provisions Congress had in mind but with the innumer-

able variations of expression of which our language is capable. It is, therefore, fair to conclude that, if the undoubted purpose of Congress is to be observed, Section 26 (c)(1) and (2) of the 1936 Revenue Act must be construed to cover contracts,—including notes and mortgages, as the Taxpayer has shown Congress had in mind,—substantially, even if not with technical exactitude, within the requirements of said Section 26 (c). *Chess & Wymond, Inc. v. Glenn Collector* (Ky., 1941) 40 F. Supp. 666, 670.

The Court should give great weight to the legislative intent that Section 26 (c)(2) be liberally construed to bring the appropriate provisions of corporate contracts, including Taxpayer's note and mortgage and its performance thereof, within said Section.

In the case of *United States of America v. Katz*, (1926), 271 U. S. 354, 46 S. Ct. 513, 70 L. Ed. 986,—opinion rendered by Justice Stone,—the Supreme Court of the United States held, as disclosed in the second branch of the syllabus (70 L. Ed. 986):

> "2. In ascertaining the purpose of the legislature in enacting a statute the court may examine the title of the statute, the source in previous legislation of the particular provision in question, *and the legislative scheme or plan by which the general purpose of the act* is to be carried out."

The Supreme Court of the United States cited the following pertinent authorities in support of this proposition (70 L. Ed. 986, 989): *United States v. Fisher*, 2 Cranch, 358, 386, 2 L. Ed. 304, 313; *United States v. Palmer*, 3 Wheat. 610, 631, 4 L. Ed. 471, 477; *Church of the Holy Trinity v. United States*, 143 U. S. 457, 462, 36 L. Ed. 226, 229.

As stated in *Paul and Mertens Law of Federal Income Taxation*, 1939 Cumulative Supplement, 1387, Section 32A.61:

> "Since this new tax developed a sharp controversy in the course of its passage, and since many of its pro-

> visions are particularly obscure and ambiguous, the Committee reports and to some extent the hearings will be particularly important in the search always to a greater or less degree demanded by a new statute for the congressional intent underlying the language of the Act as finally passed."

See also *Paul and Mertens Law of Federal Income Taxation*, 1939 Cumulative Supplement, 1388-1390. And it is said in an article discussing the 1936 Revenue Act by Homer Hendricks, "The Undistributed Profits Tax," 46 *Yale Law Journal* 19, at page 25:

> "It would seem that since the section (26 (c)(2) 1936 Internal Revenue Act) under consideration was designed to ameliorate a high-rate tax, it should be liberally construed in favor of the taxpayer." (Parenthetical matters ours.)

2. SUMMATION OF ARGUMENT ON LEGISLATIVE INTENT THAT SECTION 26 (c)(2) SHOULD BE LIBERALLY CONSTRUED AS SHOWN BY THE HISTORY OF ITS ENACTMENT.

The Taxpayer has shown that: 1. the basic intent of the 1936 Revenue Act was to tax only *undistributed* profits; 2. the Sub-Committee of the House Ways and Means Committee recommended that some relief be granted corporations bound by contracts to set aside or pay some part of their profits to discharge indebtedness or even in instances where "sound policy" required the retention of dividends by the corporations; 3. it was repeatedly brought to the attention of the House Ways and Means Committee that mortgages similar to Taxpayer's required the setting aside of a percentage of corporate profits for their retirement and that such disposition of corporate profits should be exempt from the undistributed profits surtax; 4. the legislative history of Section 26 (c)(2), cited by the Commissioner, proves only that a compromise was reached in the final bill whereby the taxable year was substituted for a

so-called "dividend" year and profits irrevocably set aside pursuant to the implied or express provisions of a contract entitled the taxpayer to a credit equally as under a contract requiring payment within the taxable year; 5. and, finally, the legislative intent to have the act apply to contracts conforming to the substance of the act and not its technical form is demonstrated by the provision of Section 26 (c)(2), in substance, that a requirement in a contract that a sum equivalent to a percentage of the profits be applied on indebtedness should be held to be the equivalent of a requirement that a percentage of such profits be so applied under Section 26 (c)(2). The foregoing facts are most persuasive evidence that this Court should construe Section 26 (c)(2) liberally, to grant Taxpayer, and taxpayers in the same position, a credit based on the performance of any written contract of indebtedness, the terms of which, under a reasonable construction, require the payment, or setting aside, within the taxable year of 1936, of some portion of their profits for the discharge of such indebtedness.

Taxpayer will further show that the general title of the 1936 Revenue Act, and the sub-titles of those sections thereof imposing a surtax on undistributed profits and granting credit against said surtax for that portion of corporate profits set aside or paid for the discharge of a debt under a written contract, are an additional demonstration of the legislative intent that Section 26 (c)(2) is to be liberally construed, and that this Court should apply that intent towards affirming the decision of the United States Circuit Court of Appeals granting Taxpayer the credit claimed.

3. SECTION 26 (c)(2) SHOULD BE LIBERALLY CONSTRUED IN THE LIGHT OF THE LEGISLATIVE INTENT SHOWN BY THE GENERAL TITLE AND APPROPRIATE SUB-TITLES OF THE 1936 ACT TAXING UNDISTRIBUTED CORPORATE PROFITS; THEREBY ANY DOUBT IS REMOVED IT COVERS TAXPAYER'S CONTRACT.

The intent of the Legislature that Section 26 (c)(2) is to be liberally construed to cover contracts such as the Taxpayer's is further found in the general title of the 1936 Revenue Act and the pertinent sub-titles thereof. Taxpayer first refers to the general title of the Revenue Act of 1936, which reads as follows:

> "AN ACT
>
> To provide revenue, *equalize taxation*, and for other purposes." 6 F. C. A., (1937) Title 26, page 13.

Considering the italicized portion of the general title of the 1936 Revenue Act quoted above in connection with its general purpose to impose a surtax on corporate *undistributed* profits, the intention of Congress is surely signified to treat all corporations who distribute their annual earnings and profits for legitimate purposes alike. It cannot and will not be presumed, Taxpayer is sure, that Congress intended to exempt from this surtax, corporate profits distributed to shareholders and impose the surtax on corporate profits distributed to corporate creditors. The intent to penalize some corporations by imposing a surtax on their profits devoted to the payment of their debts, while exempting from the surtax other corporations whose profits are distributed to stockholders, is indisputably foreign to an act which has for one of its chief purposes the intent to "equalize taxation." Nor will this Court, Taxpayer believes, so construe Section 26 (c)(2) of the Revenue Act of 1936 to penalize Taxpayer because it was inescapably required to pay $46,500.00 on its note and mortgage to the Bank, if by a reasonable construction, Section 26 (c)(2) can be made to apply. Taxpayer will hereinafter show in Subdivision VII, Sections 4, 5 and 6, of its Brief that such

a construction of Section 26 (c)(2) is not only possible, but is in fact a wholly logical one.

The construction of Section 26 (c)(2) of the Revenue Act of 1936 should be consistent with the purpose of that Act,—as shown by its general title,—to "equalize" taxation, as between corporations which, in 1936, distributed their annual earnings to their stockholders, and those other corporations, such as the Taxpayer, which distributed a portion of their annual earnings to their stockholders and also set aside and paid a portion of their earnings to their creditors under compulsion of written contracts.

As stated in *U. S. v. Katz* (1926), 271 U. S. 354, 70 L. Ed. 986,—opinion by Justice Stone,—in the second branch of the syllabus (70 L. Ed. 986):

> "2. In ascertaining the purpose of the legislature in enacting a statute the court may examine the title of the statute, the source in previous legislation of the particular provision in question, and the legislative scheme or plan by which the general purpose of the act is to be carried out."

See also *Maguire v. Commissioner* (1941), 61 S. Ct. 789.

The rule of statutory interpretation, above quoted, was applied in an analogous instance in the case of *McNally v. Field* (1902), 119 Fed. 445. In the McNally case, the court had in issue before it an Act of Congress of March 2, 1901, amendatory to the original Act of June 13, 1898 (U. S. Comp. St. 1901, page 2284), also known as the Spanish War Revenue Act. The Amendatory Act of March 2, 1901, as disclosed by its title was to "reduce taxation" under the original act. The decision of the court, in favor of the taxpayer in that case, was largely influenced by its interpretation of the statute in issue in the light of the announced purpose of the Act as set out in the title. The principle of the case only, and not the facts, are important in this connection. The Court held, illustrative of Taxpayer's contention at page 447 of its opinion:

"Under such circumstances it is not reasonable to conclude that it was the purpose of Congress, in an Act to *reduce* taxation to change the policy which it has followed since the adoption of the War Revenue Act of 1862 * * *. Certainly a conclusion of this character should not be reached *in the absence of a clear and unmistakable intention on the part of congress.* Such a conclusion should rest on a stronger foundation than an interpretation of an ambiguous statute which leads to such a result."

As Taxpayer has heretofore pointed out, since the contracts eligible under Section 26 (c)(2) must have been in existence prior to the passage of that Act and such contracts, therefore, were not formulated to comply therewith, it should be logically presumed that Congress intended in that statute to cover even contracts which were within the reason and substance of Section 26 (c)(2), though not technically conforming to it. *Chess & Wymond, Inc. v. Glenn, Collector,* 40 F. Supp. 666, 670, *ante.* No other construction is, logically, consonant with its announced purpose to "equalize taxation,"—in this instance,—as between corporations declaring dividends to stockholders and corporations setting aside and paying out their profits to retire indebtedness under the obligations of a contract so to do.

Under the authorities quoted above, the cardinal rule of interpretation as applied in this case is that this Court should construe Section 26 (c)(2) herein as applicable to Taxpayer's contract in order to equalize, proportionately, its income tax with that of other corporations who distributed their profits to stockholders,—they being under no contractual compulsion to do otherwise.

Another aid to the construction of Section 26 (c) (2) in respect to its application to the provisions of Taxpayer's note and mortgage, is the sub-title of Section 26 (c) of the Internal Revenue Act of 1936, which reads: "CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS," and the title of sub-

section 26 (c)(2), which is: "DISPOSITION OF PROFITS OF TAXABLE YEAR." 6 F. C. A. (1937) 51, Title 26, Section 26. The titles of these subsections show that Congress intended in the sub-sections following the titles to grant a credit against the surtax imposed on corporate undistributed profits, to the extent such profits were not declared as dividends because of contracts requiring the corporation to otherwise dispose of such profits. In other words, Congress disclosed its intent in the sub-titles of Sections 26 (c) and 26 (c)(2), not to penalize corporations who, because of binding contracts, were unable to escape the surtax by paying out their profits in dividends.

—In case of doubt as to whether the payments from profits made in 1936 on its mortgage and note, in evidence in this case, are a proper basis for its claimed undistributed profits surtax credit, the inference in the Taxpayer's favor from the sub-titles of Sections 26 (c) and 26 (c)(2) should influence the Court to allow such credit,—especially, since Taxpayer, had it not been for such mortgage and note, could have avoided the tax by paying the money in dividends. In the case of *Knowlton v. Moore* (1900), 178 U. S. 41, 44 L. Ed. 969, the United States Supreme Court had under consideration a Federal Revenue Act imposing a tax upon legatees. The court held, in the opinion rendered by Justice White, as disclosed by the second and fourth branches of the syllabus (44 L. Ed. 970):

> "2. The heading to a section of a statute is proper to be considered in interpreting the statute, when ambiguity exists and a literal interpretation will work wrong or injury.
>
> • • •
>
> 4. A particular construction of a statute which will occasion great inconvenience or produce inequality and injustice is to be avoided, if another more reasonable interpretation is present in the statute."

The Supreme Court cited in support of the rule of syllabus 2, the following cases (20 S. Ct. 756): *U. S. v. Fisher*,

2 Cranch, 358, 386, 2 L. Ed. 304, 313; *U. S. v. Palmer*, 3 Wheat. 610, 631, 4 L. Ed. 471, 477; *U. S. v. Union P. R. Co.*, 91 U. S. 72, 23 L. Ed. 224; *Smythe v. Fiske*, 23 Wall. 374, 280, 23 L. Ed. 47, 49; *Coosaw Min. Co. v. South Carolina*, 144 U. S. 550, 36 L. Ed. 537, 12 Sup. Ct. Rep. 689.

Therefore, should any doubt exist from the language of Section 26 (c)(2) as to its application to Taxpayer's note and mortgage, the general title of the Revenue Act of 1936 and the sub-titles of the sub-sections granting a credit in respect to contracts restricting the payment of dividends demonstrate the intent of Congress that said sub-sections should be liberally construed, and such doubt of the Court should be resolved in favor of the credit Taxpayer claims.

Taxpayer now wishes to establish the correctness of the decision of the court below that the pertinent provisions of its note and mortgage fall expressly within the provisions of Section 26 (c)(2) of the Revenue Act of 1936.

4. THE APPROPRIATE PROVISION OF SECTION 26 (c)(2) OF THE 1936 INTERNAL REVENUE ACT AND THE PROVISIONS OF PETITIONER'S NOTE AND MORTGAGE WHICH REQUIRED THE APPLICATION OF FORTY PER CENT. (40%) OF TAXPAYER'S NET EARNINGS IN PAYMENT, WHEN RIGHTLY VIEWED, ARE SYNONYMOUS.

Taxpayer will demonstrate that the decision of the court below is correct and just by showing, first, that the applicable provisions of its note and mortgage fully complied with the provisions of Section 26 (c)(2), and second, that Taxpayer's payment of $46,500.00 out of its 1936 profits on said note and mortgage was in strict performance of the conditions of Section 26 (c)(2) in that respect, as well as of the pertinent provisions of the note and mortgage requiring the application of its 1936 profits to the discharge of its said indebtedness.

It is not disputed in the record in this case, that Taxpayer's contract was executed prior to May 1, 1936, and

that the provisions of the contract in issue expressly dealt with the disposition of earnings and profits of the year 1936, all as required by Section 26 (c)(2) of the 1936 Revenue Act.

It will, of course, be conceded by the Commissioner that the use of the term "net earnings" in Taxpayer's note and mortgage does not make Taxpayer ineligible for the credit claimed under Section 26 (c)(2). Regulations 94, U. S. Treasury Department, Bureau of Internal Revenue, governing the administration of the Revenue Act of 1936, so rules at page 123, as follows:

> "A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of 'net income,' 'net earnings,' or 'net profits.'"

The Commissioner also will probably admit, and cannot logically contend to the contrary, that the provisions of Taxpayer's note and mortgage in issue in this case are not included in any of the four types of contractual provisions defined in Treasury Regulations 94, as not conforming to the requirements of Section 26 (c) (2). U. S. Treasury Regulations 94, page 123.

Taxpayer has already demonstrated that the provisions in its note and mortgage (Exs. 2 and 3, OR. 85-102) requiring the payment on said indebtedness of 40% of Taxpayer's annual earnings in every calendar year after January 1, 1934, are paramount to the provisions of said instruments requiring payments to be made in specific amounts on specific dates. Taxpayer's Brief, Subdivision VII, A, 2, *ante*.

Taxpayer is convinced it can clearly show that in every respect, not already specifically demonstrated, Taxpayer's note and mortgage conform to said Section 26 (c)(2). In Subdivision VII, B, Section 7, of Taxpayer's Brief, *post*, Taxpayer will support its contention that it irrevocably set

aside and paid $46,500.00 of its earnings and profits pursuant to its contract and in conformity to Section 26 (c)(2) of the Revenue Act of 1936, and is entitled to full credit accordingly in respect to its 1936 Undistributed Profits Surtax. Taxpayer, in Subdivision VII, B, Sections 8 and 9 of its Brief, *post*, will conclude by quoting and discussing certain precedents and authorities which, it believes, should resolve in favor of Taxpayer's contentions, the slightest remaining doubt in the mind of this Court that Section 26 (c)(2) applies to Taxpayer's note and mortgage and that the decision of the lower court should be affirmed.

5. TAXPAYER'S NOTE AND MORTGAGE REQUIRED IT TO IRREVOCABLY SET ASIDE, IN THE YEAR 1936, FORTY PER CENT. (40%) OF ITS EARNINGS AND PROFITS, TO PAY THAT INDEBTEDNESS IN CONFORMITY TO SECTION 26 (c)(2) OF THE REVENUE ACT OF 1936.

Taxpayer contends, and the tribunals below unanimously held that the provisions of its note and mortgage, requiring it to apply 40% of its net earnings to the payment of its note and mortgage, conform strictly to Section 26 (c)(2) of the Revenue Act of 1936. The most serious question the Commissioner raises as to Taxpayer's note and mortgage—and Taxpayer contends that upon analysis the question resolves itself affirmatively for Taxpayer—is that while Taxpayer was indisputably required to "apply" 40% of its earnings in 1936 on the balance due, if needed, to pay it in full, a provision contained only in Taxpayer's mortgage, provided that "settlement" for amounts of such earnings could be made on April 15, 1937. Ex. 2, OR. 85; Ex. 3, Article I, Section (1), OR. 91. Because of this latter provision of the Taxpayer's mortgage, Commissioner contends that Taxpayer's note and mortgage, although admitted to deal with profits in the taxable year 1936, do not require the payment or irrevocable setting aside of such profits in that year. The court below held to the contrary,—that, giving the words "apply" and

"settlement" their natural meaning in respect to their relation to each other and as intended by the parties to the note to protect the legitimate interests of the Bank and Taxpayer, the conclusion is inescapable that Taxpayer was bound under said note and mortgage to irrevocably set aside the required portion of its earnings to pay that indebtedness within the literal terms of Section 26 (c)(2).

Taxpayer, first, proposes to briefly quote the accepted definitions of the phrase used in Section 26 (c)(2) "irrevocably set aside" and point out certain synonyms which could be properly substituted without altering one iota the scope of Section 26 (c)(2), but which Taxpayer believes will prove its contention. Taxpayer will then set out accepted definitions of the words "apply" and "settlement," show with what meaning, under the circumstances and mutual intent of the parties to said debt, those words were used in Taxpayer's note and mortgage. Having so done, Taxpayer is sincerely convinced that it will have shown its note and mortgage are, in every respect, in conformity to Section 26 (c)(2) of the 1936 Revenue Act.

Taxpayer gives attention, first, to the words of Section 26 (c)(2) which are here specifically in issue: "irrevocably set aside."

Webster's New International Unabridged Dictionary (1934, 2d Ed.) defines the word "irrevocable" as: "Incapable of being recalled or revoked; past recall; unalterable."

Funk & Wagnall's New Standard Dictionary (1935) defines "irrevocable" as: "Not to be changed by the doer or maker."

Webster's New International Dictionary, supra, defines the phrase "set aside" as: "To set apart for a purpose; reserve; as, to set aside part of one's income."

Taxpayer wishes to emphasize the last-quoted definition of the phrase "set aside," as Taxpayer believes it can

establish that the word "apply" can be correctly used to mean the same thing as to "set aside" and that, in order to give effect to both "apply" and "settlement," used in Taxpayer's note and mortgage, the word "apply" must be taken to mean "set aside."

Turning to the authoritative definitions of the word "apply," it appears, as Taxpayer has intimated, to have more than one meaning, either of which might be inferred from that word as used in Taxpayer's note and mortgage, —provided it were not necessary, under the rules governing the construction of contracts, to give equal effect to the word "settlement."

In *Webster's New International Dictionary, supra,* the word "apply" is defined as:

> "To put to use; to use or employ for a particular purpose or in a particular case; *to appropriate,* allot; devote; as to apply money to the payment of a debt."

And similarly in I *Oxford English Dictionary* (1933) 407, the term "apply" is defined as:

> "To put to a special use or purpose, to devote, *appropriate to.*"

And in 1 *Bouvier's Law Dictionary* (3rd Rev.) 214, the word, "application," meaning the act of applying, is defined as:

> "the use or *disposition* made of a thing."

It is Taxpayer's contention that the meaning attributable to the word "apply" as used in Taxpayer's note and mortgage connotes appropriation of Taxpayer's profits in the sense of setting apart or setting such profits aside for future payment. *Webster's New International Dictionary, supra,* supports this meaning of the word "apply" as "to appropriate," in exactly the sense contended for by Taxpayer.

Webster's definition of the word "appropriate" is:

"to set apart for."

And in I *The Oxford English Dictionary, supra,* 407, the word "appropriate" is held to mean:

> "to devote, *set apart,* or assign to a special purpose or use."

Referring back to the definitions just quoted in Taxpayer's Brief, we have shown that the words "set aside" as used in Section 26 (c)(2) also means "to set apart," or "appropriate," which are also synonyms for the word "apply."

Taxpayer, therefore, not only has shown that an authoritative meaning of the word "apply" is to "set apart or set aside," but also will show by undoubted authority that the word "apply" is frequently used in law in such sense in Taxpayer's note and mortgage.

In 3 *Words and Phrases* (Perm. Ed.) 760, in illustrating the meaning of the word "apply," as contended for by Taxpayer, it states:

> " 'Apply,' as used in a statute authorizing a trustee to receive the rents and profits of lands, and 'apply' them to the use of any person means the act of applying, and includes any act of the trustee by which the trust fund is applied for the benefit of the *cestui que trust,* whether expressly directed by the donor or permitted according to the discretion of the trustee; and hence a will creating a trust to receive rents and profits of land and pay them over to the beneficiary is valid. *Leggett v. Perkins,* 2 N. Y. (2 Comst.) 297, 309."

And in the same volume of 3 *Words and Phrases* (Perm. Ed.) 457, it also is said:

> " 'Applied,' as used in a will directing that a specific portion of rents, issues, and profits shall be 'applied' to the education and support of testator's children during their minority, is substantially equivalent to

'paid over.' *Moorehouse v. Hutchinson*, 2 N. Y. Suppl. 215, 217."

In both the examples given above from *Words and Phrases*, the courts construed the word to mean, first, the receipt of money, and, second, its irrevocable setting aside for a future payment when the contingency, as defined in the instrument under construction, arose. So, in the case at bar, Taxpayer has shown the circumstances surrounding the future performance of Taxpayer's note and mortgage which made it the intent of the parties that Taxpayer was irrevocably obligated to set aside its net earnings or profits amply equivalent to guarantee that upon the happening of the contingency of an accurate determination of Taxpayer's profits for the calendar year, forty per cent. (40%) of said accrued profits would be available and paid on said indebtedness—the time of said determination and payment not to be later than April 15th of the year following that in which said profits were earned.

As the next logical step in the discussion of this question, Taxpayer refers to the accepted definitions of the word "settlement." In this connection, it is stated in 39 *Words and Phrases* (Perm. Ed.) 33:

> " 'Settle' is said to be a word of equivocal meaning; and to mean different things in different connections, and that the particular sense in which it is used may be explained by the context or the surrounding circumstances. Accordingly, the term may be employed as meaning to agree, to arrange, to ascertain, to come to or reach an agreement, *to determine*, to establish, to fix, to free from uncertainty, to place, or to regulate. *Edwards v. Edwards*, Tex. Civ. App., 52 S. W. (2d) 657, 661."

The word "settlement," as used in Taxpayer's mortgage (Ex. 3, Article I, Section (1), R. 91), Taxpayer believes, is used in the sense of a final determination,—acceptable to the Bank,—of the amount in dollars of forty per cent. (40%) of the net earnings of the Taxpayer for the

preceding year,—less any payments theretofore made out of said profits,—and the payment over to the Bank of the net balance due. "Settlement" is defined in this sense in 39 *Words and Phrases* (Perm. Ed.) 35, as:

> "The word 'settlement' is defined as the act or process of adjusting or determining; an adjusting; an adjustment between persons concerning their dealings or difficulties; an agreement by which parties having disputed matters between them reach or ascertain what is coming from one to the other; arrangement of difficulties; composure of doubts or differences; determination by agreement; and liquidation. *Sowers v. Robertson*, 58 P. (2d) 1105, 1107, 144 Kan. 273."

And in 39 *Words and Phrases* (Perm. Ed.) 42, the word "settle" is defined as:

> "A promise to 'settle' a liquidated demand, respecting which there was no dispute between the parties, is a promise to pay the same."

And in 3 *Bouvier's Law Dictionary* (3rd Revision, 1914), 3054, "settlement" in contracts is defined as "payment in full."

Taxpayer wishes to again recall to the Court the circumstances under which the words "apply" and "settlement" were used in the provisions of the note and mortgage in issue. These circumstances impel the inevitable conclusion that the terms "apply" and "settlement" were advisedly used in the exact sense contended for by Taxpayer and likewise, entirely consonant with the sense in which "irrevocably set aside" is used in Section 26 (c)(2).

The Taxpayer has heretofore shown that it was the deliberate requirement of the Bank and the bondholders whom it represented, that a large percentage of the prospective earnings of the Taxpayer be pledged under the note and to forfend against, as far as possible, the bondholders having again to take back and dispose of,—to their sorrow,—the plant and equipment purchased by Taxpayer, in order to recoup their investment. OR. 38. Taxpayer's

brief, subdivision VII, A, 2; *ante*. While the Taxpayer was indisputably willing to accede to this requirement,—as evidenced by the completed contract,—both Taxpayer and the Bank were cognizant that as an industrial concern, Taxpayer's net earnings could not be accurately determined and the performance of the contract, in this respect, practically consummated, until a physical inventory of its assets, including large amounts of raw materials, goods in process, and finished goods, had been taken.

This will, of course, be conceded by the Commissioner. In Article 22(c)-1 of United States Treasury Department, Regulations 94, governing the administration of the Revenue Act of 1936, page 38, it states:

> "NEED OF INVENTORIES.—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case *in which the production, purchase, or sale of merchandise is an income producing factor*. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory mechandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected."

Article 22 (c)-2 provides:

> "VALUATION OF INVENTORIES.—Section 22 (c) provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

• • •

An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as *clearly reflecting his income.*" Regulations 94, pp. 38 and 39.

It will be further noted as establishing the importance of a physical inventory in accurately determining the net income of an industrial concern that U. S. Treasury Regulations for the preparation of inventories of concerns such as Taxpayer's require four closely printed pages. U. S. Treasury Regulations 94, pp. 38 to 42.

Taxpayer, also, again refers, in support of its contention as to the reason for this provision regarding "settlement" in its note and mortgage, to the testimony of Sidney J. Collins, Taxpayer's auditor, that it was and is an utter impossibility for the Taxpayer to have computed its net profits with sufficient accuracy to constitute a performance of any contract that required the payment of a percentage of the year's earnings at the close of the last working day in that year. PR. 24, *et seq.* Taxpayer's Brief, subdivision VII, A, 1, *ante.*

Congress was thoroughly informed of the fact that annual profits of manufacturing concerns could not be accurately determined within the year earned when it was considering the Revenue Act of 1936. For illustration, Taxpayer refers to the testimony of Mr. Scott Russell, representing the Cotton Textile Institute, who testified as shown in the report of Hearings Before The Senate Finance Committee on the Revenue Act of 1936, 380, at page 385:

"May I, Senator, just indulge in one more statement with reference to this question? The Treasury

> Department has always recognized, and now incorporates in regulation 86, article 22, the statement that no mill, no business in which the manufacture of goods is an income-producing factor, can possibly show a correct income without the use of inventories."

Taxpayer also refers to the testimony of Honorable Arthur A. Ballantine, former Assistant Secretary of the Treasury on this subject, as set out in said Report of Hearings Before the Senate Finance Committee on the Revenue Act of 1936, 415, at page 417, where Mr. Ballantine states:

> "Unless there is a period after the close of the taxable year, the year for which we are determining the income, in which the corporation can determine its distribution, I do not see how this measure could possibly work at all, because at the end of a year there are all kinds of adjustments, in many corporations which have to be made. Then when they finally take and look at their inventories, they go over their accounts receivable, they look ahead at their problems, and they cannot make an accurate determination within the year. There must be some period in practical experience after the close of the year for any enterprise of any size to determine its income."

Taxpayer contends that since the attention of Congress was repeatedly called to the impossibility of computing annual profits within the year at the time Section 26 (c)(2) of the 1936 Revenue Act was being considered, it, undoubtedly, intended that under Section 26 (c)(2) a contract that implicitly required an irrevocable setting aside of profits for payment would equally conform to the statute as a contract which expressly required *payment* of profits on an indebtedness within the taxable year. Taxpayer has shown in its Brief, subdivision VII, B, 5, *ante*, that the requirement to apply 40% of its profits is the equivalent to "irrevocably setting aside" such profits.

Returning to the circumstances under which the words in issue were inserted in Taxpayer's note and mortgage, it

is to be presumed that Taxpayer's accountant was called in for advice as to these important provisions of the contract, as he was in regard to the performance thereof (PR. 23-24), and that his advice was followed, resulting in the insertion of the provision extending the maximum time of determining profits for the preceding year and making payment accordingly to April 15th of the following year.

Likewise, keeping in mind the paramount purpose of the Bank and the bondholders it represented, that 40% of the profits should be irrevocably segregated for the payment of the note and mortgage, the Bank would naturally insist that,—notwithstanding, it would be impossible to determine the net profits until subsequent to the end of the year in which they accrued,—that such provision must be made in the mortgage as would require Taxpayer to earmark and irrevocably set aside sufficient earnings to assure that when the determination of profits was made, Taxpayer's profits would be available to pay the amount so determined due the Bank. Barring the use of the words "irrevocably set aside," which, in this connection, would have removed the claim of Taxpayer in this case from the realm of any controversy, what better term in law than that of "apply" could have been used to carry out the undoubted intent of the Bank to hedge its claim to 40% of the profits with every practicable safeguard of language,—in view of the necessity of waiting for actual payment of the profits for any year until after that year had expired. As Taxpayer has shown, the word "apply" has been repeatedly used to impose an obligation upon trustees,—whose obligations are the highest known to law,—to segregate funds and, thereafter, pay such funds upon the happening of a future event to the *cestui que trust*. Taxpayer's Brief, subdivision VII, B, 5, *ante*. It is submitted that the function of the Taxpayer under this obligation was analogous to that of a trustee, obligated to preserve a fund for future payment,—until Taxpayer's earnings for the

year were accurately determined, the amount due finally settled and paid over,—and that the word "apply" was the best possible word to have used to impose that obligation. Taxpayer's Brief, subdivision VII, B, 6, *post*. To draw together the definition of the words, "irrevocably set aside," used in Section 26 (c)(2) and the natural and inescapable meaning of the word "apply," we refer to an illustration of the use of the words, "set apart" in the same sense as we have shown the word "apply" is used, in 39 *Words and Phrases* (Perm. Ed.), page 7, which states:

> "Text-writers, in using the terms 'set aside,' 'set apart' and 'actually set apart' with reference to dividends, proceed on the theory that the act of declaring a dividend, operating, as it does, as an actual severance of the dividend from the stock and corpus of the corporate property, is *ipso facto*, in and of itself, the setting apart, setting aside, and segregating such dividend in the sense that it creates an immediate right of the stockholder to demand and recover the same when due. * * *." *McLaren v. Crescent Planing Mill Co.*, 93 S. W. 819, 822, 117 Mo. App. 40.

Applying a practical test to Taxpayer's construction of the obligation imposed upon Taxpayer by the word, "apply," can it be supposed for one moment that the Bank would in the mortgage and note leave a loophole whereby the Taxpayer under that contract had any option to make any disposition of its profits and earnings as they accrued during the year, which would, in the slightest degree, prejudice the Bank's receipt of 40% of said profits on said note and mortgage,—consonant with the necessity of delay until a determination of the profits could be accurately made? The argument of the Commissioner at page 18 of his brief that Taxpayer was free to use this percentage of earnings for purchase of new equipment or investment is a direct contradiction of and proof of, the Commissioner's statement immediately following, in substance, that Taxpayer was legally obligated to maintain the fund

for the creditors. The answer to the claim of the Commissioner that the fund could be used to purchase equipment or for permanent investment, Taxpayer submits, is inescapably no, and that every intendment of the contract is that the necessary portion of the profits required to secure performance of this obligation be irrevocably segregated until paid to the Bank.

The obligation was "The Company will apply forty percentum (40%) per annum of its net earnings, etc." Taxpayer's note and mortgage does not even leave the loophole of language such as used in Section 26 (c)(2) heretofore quoted, reading so far as pertinent:

> "an amount *equal* to a percentage of earnings and profits, etc."

In short, how can it be consistently contended by the Commissioner that if the irrevocable setting aside of "an amount equal to a percentage of earnings and profits, etc." shall be considered a requirement to pay or set aside such percentage of earnings and profits within the terms of Section 26 (c)(2), that the direct obligation of Taxpayer to "apply" is not also, and equally, an obligation to irrevocably set aside the earnings so governed? Taxpayer submits there is no answer but that the obligation imposed on Taxpayer, to apply 40% of Taxpayer's earnings, is an obligation to irrevocably set aside 40% of its earnings in the taxable year 1936 to discharge said indebtedness.

Summarizing, therefore, this subdivision of Taxpayer's Brief, Taxpayer contends that it has shown that because of the practical necessities of the situation, in which both the Bank and Taxpayer were, when this note and mortgage in issue were entered into, the word "apply" was used in an advised and considered sense to impose a trustee-like obligation upon the Taxpayer to "irrevocably set aside" 40% of its profits or earnings within the taxable year 1936, in strict conformance to the terms of Section 26 (c)(2) of the Internal Revenue Act of 1936.

6. TAXPAYER'S OBLIGATION TO APPLY 40% OF ITS 1936 PROFITS ON ITS MORTGAGE INDEBTEDNESS, FINAL SETTLEMENT TO BE MADE IN THE SUCCEEDING YEAR, RAISED AN IMPLIED OR CONSTRUCTIVE TRUST IN RESPECT TO SUCH PROFITS REQUIRING AN IRREVOCABLE SETTING ASIDE THEREOF, CONFORMING TO SECTION 26 (c)(2).

Taxpayer has previously shown in its brief, subdivision VII, B, 5, that the provisions of its note and mortgage requiring it to apply 40% of its net earnings on its note and mortgage indebtedness, required it to irrevocably set aside such portion of its profits. Its exact legal function is construed to be that of a trustee. The violations of the Taxpayer of such obligation would, under the mortgage, have resulted in a default and consequent severe penalties as follows:

1. The declaration of the entire remaining unpaid principal due and payable.

2. Suit for such balance and interest, together with further interest at the rate of 6% per annum.

3. Sale at public auction of the entire plant and equipment of the Taxpayer, at its expense, including all attorney and counsel fees.

4. Entry into possession by the Bank of the Taxpayer's plants and equipment and the exclusion therefrom of the Taxpayer's officers and agents, with exclusive right in the Bank to thereafter collect all income, rents, issues, and profits of such property.

5. Any other remedy allowed by law or equity against the Taxpayer, in addition to any of or all of the foregoing. Taxpayer's Mortgage, Ex. 3, Art. IV, PR. 35-37.

An analogous situation was presented in *Marine Midland Trust Co. v. Alleghany Corporation* (D. C. N. Y. 1939), 28 F. Suppl. 680, wherein the Alleghany Corporation had agreed in a bond indenture to secure its obligation with

collateral at all times during the life of the indebtedness, to the value of 150% of the principal amount of the outstanding bonds. The court held that this contract right was enforceable in equity by a suit for specific enforcement. Certainly, an equitable obligation having been imposed on the Taxpayer by the provisions of the note and mortgage requiring 40% of its net earnings to be applied on the indebtedness, an equitable lien in favor of the Bank was imposed upon such percentage of its earnings. See also *Commissioner v. Strong Mfg. Co.* (1941), 124 F. (2d) 397; I *Restatement of the Law of Trusts*, 32, Section 10a.

Applying the principle developed, the conclusion follows that Taxpayer was the Trustee of 40% of its 1936 profits which it was irrevocably required to set aside for the discharge of its note and mortgage.

Taxpayer will now show that Taxpayer irrevocably set aside within the taxable year 1936, $46,500.00 for the discharge of its said indebtedness and paid it thereon in conformity to its contract and to Section 26 (c)(2) of the 1936 Revenue Act, and that Taxpayer is thereby clearly entitled to the income tax credit it claims under said section.

7. TAXPAYER, IN 1936, UNDER THE OBLIGATION OF ITS WRITTEN CONTRACT, IRREVOCABLY SET ASIDE $46,500.00 OF ITS 1936 PROFITS FOR THE PAYMENT OF ITS NOTE AND MORTGAGE HELD BY THE CENTRAL UNITED NATIONAL BANK OF CLEVELAND.

Taxpayer contends that in setting aside and, admittedly, paying $46,500.00 out of its 1936 profits, in discharge of its note and mortgage, it conformed to Section 26 (c)(2) of the 1936 Revenue Act, as well as to the obligation of its contract. The profits of Taxpayer as shown by its 1936 Income Tax Return were $126,786.04. Ex. 1, OR. 67. Forty per cent. (40%) of said profits is $50,714.42. The balance due on Taxpayer's note and mortgage as of January 1, 1936, was $47,000.00, plus interest. OR. 39. The items of interest paid in 1936 by Taxpayer are not in dispute here,

as the Commissioner has already allowed due credit on Taxpayer's 1936 income tax therefor. As Taxpayer has shown, it was under strict obligation to irrevocably segregate, and did segregate, forty per cent. (40%) and more of its profits as they accrued during the year 1936, until it had paid off said note and mortgage. Taxpayer not only set aside, irrevocably, from its profits earned in 1936 the amount needed to discharge its note and mortgage, but also, in 1936, paid over the money to the Bank. Such payment was utterly consistent with Taxpayer's obligation to irrevocably set aside that amount for such purpose. No segregation by Taxpayer of said profits for such purpose could be as irrevocable as actual payment to the Bank. Taxpayer was amply justified in so doing, for its profits on September 30, 1936, estimated with the best possible degree of approximation,—and barring any losses in the rest of the year which would cancel such profits,—were $86,000.00. OR. 46. Having in mind additional savings in interest that might be effected by anticipating the maximum due date of principal payments, the forgiveness of $500.00 on the principal, which the Bank agreed to allow, when approached on the subject, and the further savings in income tax which could be effected under Section 26 (c)(2), Taxpayer took counsel with its attorney and its auditor. PR. 24. In addition to the profits mentioned, it appeared in September of 1936 that Taxpayer had *orders* on its books in the total amount of $100,000.00. OR. 44. Weighing all these facts, and particularly to fulfill every possible intendment of Section 26 (c)(2), Taxpayer's attorney and accountant advised that payment be made of the balance due on Taxpayer's note and mortgage. Taxpayer's auditor, Sidney J. Collins, C. P. A., testified as to these conferences and conclusions, as set out on page 24 of the Record, as follows:

> "Q. Was there any conference prior to the payment of these sums or any part of these sums by the Strong Manufacturing Company to the Central United National Bank on which your advice was asked?

A. Yes. In September of 1936 the President and Treasurer of the company and their counsel, Mr. Morgan, invited us to a conference on the question of the payment of the mortgage and its requirement under this contract. There were several discussions with other attorneys on the point, and the Treasurer showed the profits to September 30th, which we checked on the books, and they also—that is, the Treasurer submitted evidence of future earnings for the balance of that year. Insofar as it is possible, we determined this, reported to the company officials our estimate that profits would be in excess of forty per cent. *That, of course, would be subject to something that might happen during the year after September 30th.* However, it was our recommendation that since the profits were to be such that forty per cent, being in excess of the requirements of this contract, if they were able financially to do so, that they would pay during the year on the contract. Does that answer your question?"

In other years Taxpayer had been less fortunate, having been forced to obtain a written extension from the Bank of its payments due in the year 1934, in order to preserve its working capital needed for its business. OR. 40. It will be noted in connection with the provisions of the note and mortgage in controversy that said extension provided, in its first paragraph, that it was granted

"with the understanding, however, that such extension shall not be construed as a waiver of any subsequent defaults." *Ex. 4, paragraph 1, OR. 102.*

See also Ex. 3, Article IV, Section 2, PR. 35, providing that no waiver by the Bank of any default shall be construed as a waiver of any subsequent default.

Section 26 (c)(2) provides,—pertinent to the performance of its terms that specifically entitle Taxpayer to the claimed credit as against its corporate surtax,—that Taxpayer is entitled to such credit "to the extent that such amount has been so paid or set aside," for the discharge of said indebtedness. Taxpayer contends that its 1936 profits, in the amount of $46,500.00, so paid in discharge of

its indebtedness had, until payment, been irrevocably set aside for that purpose,—otherwise, obviously said "net earnings" could not have been available. It is undisputed in the Record that all payments in 1936 were made out of earnings. OR. 44-45. Finally, Taxpayer points out that the credit granted by Section 26 (c)(2) under Taxpayer's qualifying contract is based on amounts which are "set aside *or* paid out," so that Taxpayer is eligible whether it is held to have irrevocably set aside the profits in 1936 *until* paid to the Bank, or by reason of the actual payment of the note and mortgage—both acts having been fully completed in the taxable year of 1936.

Summarizing, therefore, Taxpayer has shown that the payment of $46,500.00 out of its profits in 1936 to discharge its note and mortgage was less than 40% of its earnings of that taxable year; that said payment was literally and in substance in strict performance of a provision of a written contract dealing with earnings, requiring Taxpayer to irrevocably set aside said profits until paid in the discharge of an indebtedness, and that Taxpayer's note and mortgage, being in conformity to Section 26 (c)(2), the performance thereof by Taxpayer met the requirements of that statute in, first, irrevocably setting aside $46,500.00 of its profits and, second, in paying said amount to its debtor,—either of which acts entitles it to the credit claimed,—Taxpayer having performed both acts within the taxable year, 1936.

Taxpayer sincerely believes that it has demonstrated that the provisions of its note and mortgage, and its performance thereof within the taxable year 1936, in issue here, clearly entitles it to the credit claimed in respect to its corporate surtax under Section 26 (c)(2) of the 1936 Revenue Act. Any further doubt as to the propriety of Taxpayer's claim should be resolved in its favor under the rules of interpretation of the Federal Tax Statutes announced by the courts and the precedents construing Section 26 (c)(2), hereinafter set forth.

8. SECTION 26 (c)(2) OF THE 1936 INTERNAL REVENUE ACT SHOULD BE GIVEN A COMMON SENSE AND PRACTICAL CONSTRUCTION ACCORDING TO ITS INTENT, AND TAXPAYER'S CONTRACT SHOULD BE INTERPRETED, IF NECESSARY, BY ITS SUBSTANCE AND NOT ITS FORM, TO RELIEVE TAXPAYER FROM THE UNDOUBTED HARDSHIP OF THE COMMISSIONER'S DEFICIENCY ASSESSMENT.

Taxpayer, in this section of its Brief, contends that under the controlling authorities, hereinafter set out, the Court should construe Section 26 (c)(2) and the pertinent provisions of Taxpayer's note and mortgage in accordance with the realities of the situation, as reflected in the record herein. These demonstrate, Taxpayer believes, that Taxpayer was bound to irrevocably segregate its profits in the year 1936 to the extent necessary to discharge that indebtedness, and that such was done. No technical construction of Section 26 (c)(2) should be allowed to govern when a common sense interpretation shows,—as Taxpayer sincerely believes it does,—that that statute is affirmatively applicable to the fact situation in this case. The substance of Section 26 (c)(2) and the appropriate provisions of Taxpayer's note and mortgage should be determinative according to their substance, and not to some particular form they are conceived to take to the contrary.

It is the undoubted intent of Congress, as shown in Taxpayer's Brief, Subdivision VII, B, 1 and 2, that Section 26 (c)(2) be liberally construed to grant the relief thereby intended, and every doubt which arises should be resolved in favor of such legislative intent,—to relieve Petitioner under the facts in this case, from a high surtax which was intended to be assessed *only* on undistributed profits. In support of Taxpayer's contention, it cites the case of *Ruben v. Commissioner of Internal Revenue* (1938), 97 Fed. (2d), 926 (8th Circ.). In the *Ruben* case, the Commissioner of Internal Revenue sought to levy an income tax under the Revenue Act of 1928, Section 115 (a), based

on a release of the taxpayer from asserted claims against him in a large amount, it being contended by the Commissioner that this release constituted taxable income equal to the claims asserted. It was established that the taxpayer had, in fact, received no actual income from the transaction. The court in the *Ruben* case set aside the deficiency assessment and held, in the *first branch of the syllabus*, at page 926:

> "Taxation is a practical matter dealing with reality."

So, in this case, it is sought to levy a tax on a *distributed* portion of Taxpayer's 1936 earnings, when the tax, to all intents and purposes, was enacted to reach only undistributed profits. Dealing with the realities in this case Taxpayer contends the presumption should be against the tax on the distributed portion of Taxpayer's 1936 earnings in issue herein.

The contention of the Commissioner in this case is neither in accord with common sense nor standard business practice, as applied to Taxpayer's note and mortgage. The Commissioner must admit that it was, in fact, impossible for Taxpayer, in any year, to accurately compute its profits without taking an inventory after the close of business in that year. It was, therefore, necessary for Taxpayer to have this saving clause in the mortgage, which allowed a final "settlement" of the amount due by way of earnings to the Bank within a reasonable period after the close of the year,—and until April 15th of the succeeding year certainly defined such a reasonable period. No corporation would risk the imposition of the severe penalties and forfeitures contained in the mortgage in this case by permitting to be inserted therein a condition as to the payment of profits within the year earned, which was impossible of performance. Nevertheless, the terms of Taxpayer's note and mortgage, according to usual business standards, clearly earmarked 40% of Taxpayer's earnings

as they accrued, for payment on said obligation *when* the profits were determined. Taxpayer would not consider subjecting the corporation to the before-mentioned forfeitures and penalties, by taking any other view as to the requirement to "apply" said portion of the profits than that an ample portion of the profits must be set aside irrevocably to assure the strict observance of the future obligation to pay it after an accurate determination of the amount of 40% of the annual profits of the corporation had been made. The rule of common sense interpretation and that of the standard of accepted business practice has been held to apply to taxation statutes by controlling authorities. For illustration, Taxpayer refers to the case of *Rhodes v. Commissioner of Internal Revenue* (1939), 100 Fed. (2d) 966, at 969, in which the Court held:

> "Common sense interpretation is the safest rule to follow in the administration of income tax laws. Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes men should measure both by ordinary everyday business standards. Compare *Woolford Realty Co. v. Rose, Collector*, 286 U. S. 319, 332, 52 S. Ct. 568, 76 L. Ed. 1128, *United States v. Hardy*, 4 Cir. 74 Fed. (2d) 841."

And in the case of *Wesch v. Helburn* (1933), 5 F. Supp. (Dis. Ct. of Ky.) 581, Judge Dawson held, as disclosed in the first branch of the syllabus:

> "1. Reasonable and practical construction should be given to statute relating to deductions in computing income tax."

In that case a deduction was allowed the taxpayer, based on the utter worthlessness of stock in a notoriously insolvent corporation, although it was undisputed that in the year for which the deduction was claimed the stock had been sold in considerable blocks, although at only a few cents a share. A technical construction of the statute there in-

volved would have, of course, brought the opposite judgment by the court.

In the case of *Commissioner of Internal Revenue v. Ashland Oil and R. Co.* (1938), 99 Fed. (2d) 588, at page 591, the court said:

> "It has been said too often to warrant citation that taxation is an intensely practical matter, and that the substance of the thing done and not the form it took, must govern. This principle has been repeatedly invoked by the Commissioner and applied by the Board. *Carter Publications, Inc. v. Commissioner,* 38 B. T. A. 160; *Warner Co. v. Commissioner,* 26 B. T. A. 1225; *George Whittell and Co., Inc. v. Commissioner,* 34 B. T. A. 1070."

And in headnote three, the court held in the *Ashland Oil and R. Co.* case, at page 588:

> "Taxation is an intensely practical matter and the substance of the thing done and not the form it took must govern, as regards liability for income tax."

Petition for writ of certiorari was denied in this case. 58 S. Ct. 786, 83 L. E. 1057, 306 U. S. 661.

All doubt in the interpretation of Section 26 (c)(2) and of Taxpayer's contract should be resolved in favor of the Taxpayer. *Hasset v. Welch* (1938), 303 U. S. 303, 58 S. Ct. 559; *McFeely v. Commissioner of Internal Revenue* (1935), 296 U. S. 102, 56 S. Ct. 54; reh. den. 296 U. S. 664, 56 S. Ct. 304; *Old Colony R. Co. v. Commissioner of Internal Revenue* (1932), 52 S. Ct. 211, 284 U. S. 552; *U. S. v. Merriam* (1923), 263 U. S. 179, 44 S. Ct. 69; *Gould v. Gould* (1917), 245 U. S. 151, 38 S. Ct. 53; *Glenn v. Oertel* (1938), 97 Fed. (2d) 495 (6th Circ.).

It is equally well established that Taxpayer's note and mortgage should be construed according to the substance of Section 26 (c)(2), and not according to the literal words of the statute,—especially, since the statute applies to contracts entered into before its enactment, and it was

not intended to cover future contracts drafted in contemplation of its benefits. *Cooper v. Reynolds* (1932), 60 Fed. (2) 650 (Dist. Ct. of Wyo.), affirmed in *Reynolds v. Cooper* (1933), 64 Fed. (2d) 644 (10th Circ.), which was, in turn, affirmed in 291 U. S. 192, 54 S. Ct. 356. *Chess & Wymond, Inc. v. Glenn, Collector,* 40 F. Supp. 666, *ante.* As Taxpayer has repeatedly emphasized, Congress must have intended a liberal construction of Section 26 (c)(2) in order that it should apply to all contracts conforming in substance thereto, since, by its terms, it could not apply to contracts formulated with a view to obtaining the benefits of provisions of said Section 26 (c)(2), and also because Congress, as Taxpayer has shown, had mortgages and notes of the kind illustrated by Taxpayer's in mind when it enacted Section 26 (c)(2), and finally, both because of the purpose of Congress to equalize taxation,—as stated in the general title of the 1936 Revenue Act,—and its intent to exempt distributed income, as shown by the sub-titles of Section 26 (c) and Section 26 (c)(2). See Taxpayer's Brief, Subdivision VII, B, Sections 1 and 2. In the case of *Helvering v. Stockholms Enskilda Bank* (1934), 293 U. S. 84, 55 S. Ct. 50, the United States Supreme Court held, as disclosed in the seventh, eighth, and ninth branches of the headnotes (55 S. Ct. 50) as follows:

> "7. Taxing acts are not to be extended by implication beyond clear import of language used, and doubts are to be resolved against government and in taxpayer's favor.
>
> 8. Lawmaker's intention controls in construing taxing acts.
>
> 9. Lawmaker's intention in enacting taxing act is to be ascertained, not by taking word or clause from its setting and viewing it apart, but by considering it in connection with context, general purpose of statute, occasion and circumstances of its use, and other appropriate tests for ascertainment of legislative will."

It surely will be conceded by the Commissioner that it works an unusual hardship on Taxpayer to pay a high rate surtax,—which was assessed generally to penalize only *undistributed* corporate profits,—for no better reason than that Taxpayer was required under threat of the penalties in its mortgage, constituting complete forfeiture of its corporate existence, to pay to the extent of $46,500.00 of its 1936 profits in discharge of said indebtedness. Taxpayer submits that such a result was clearly not intended by Section 26 (c)(2). If there be any doubt in the mind of the Court that Taxpayer is entitled to the credit claimed, it should be resolved against the deficiency assessment made by the Commissioner and in favor of the credit asserted by Taxpayer, because of the inherent hardship of the tax. *Helvering v. Hutchings* (1941) 61 S. Ct. 653; *Reconstruction Finance Corp. v. Prud. Secs. Advisory Group* (1941) 61 S. Ct. 331; *Harrison, Collector v. Schaffner* (1941) 61 S. Ct. 759.

The statement of the case by the court below is most convincing. Speaking through Judge McAllister it said:

> "With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, accounting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation, here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.
>
> We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to 'apply' 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26 (c) (2)

of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit."

Following the rules of statutory construction and the rules equally governing the construction of Taxpayer's contract for taxation purposes set out above, Taxpayer expresses its sincere conviction that the deficiency assessment of the Commissioner asserted here is wholly unjust, contrary to the intent of the Legislature and finally, to the facts in this case, and the decisions of the Board of Tax Appeals and of the United States Circuit Court of Appeals disallowing it, should be affirmed.

9. COURT AND BOARD OF TAX APPEALS DECISIONS AFFIRM THE RIGHT OF TAXPAYER TO A CREDIT UNDER SECTION 26 (c)(2).

The decisions construing Section 26 (c)(2) of the 1936 Revenue Act granted a credit against the 1936 Undistributed Profits Surtax in the case of contracts such as Taxpayer's, where a reasonable construction of the contracts imported a definite obligation to pay, or irrevocably set aside a portion of corporate profits during 1936 and such obligation had been performed. The Commissioner here, as in the cases cited, has contended that the contracts and their performance must technically conform to the statute. The decisions have repudiated this view, and Taxpayer believes, properly, in favor of a reasonable construction of that Section.

G. B. R. Oil Corporation v. Commissioner (1939), 40 B. T. A. 738, affirmed without opinion 124 F. (2d) 396, was an early case decided by the Board of Tax Appeals under Section 26 (c)(2) of the Revenue Act of 1936. The taxpayer in that case borrowed money from a bank, in 1934, to purchase several oil leases and, in turn, was required to execute a deed of trust liens on the leased prop-

erties and written assignments to the bank of all the proceeds from the oil produced therefrom. In 1936 all of the money received from the leases was deposited in the bank, but the taxpayer was permitted to withdraw funds for current expenses and also for new developments. The Board said (40 B. T. A. 743):

> "In determining whether the claimed credit of a corporate taxpayer falls within section 26 (c)(2) and the regulations promulgated thereunder, three things seem to be necessary:
>
> "(1) There must be a written contract executed prior to May 1, 1936, which expressly deals with the disposition of earnings and profits of the taxable year.
>
> "(2) The credit relates to that portion of the earnings or profits which are required to be paid or irrevocably set aside in the discharge of a debt.
>
> "(3) The credit is allowable to the extent that the money has been so paid or set aside."

With respect to the first requirement the Board held that the fact that the year 1936 was not specifically mentioned in the assignments did not prevent the granting of the credit.

With respect to the second requirement the Board said that the fact that the bank permitted the taxpayer to use enough of the assigned funds for its current developments and operating expenses did not affect the validity of the assignment of all of the earnings.

With respect to the third requirement the Board held that the fact that the payments exceeded the petitioner's net taxable income did not affect the question because the net taxable income was probably reduced by depletion allowances. The Board of Tax Appeals in allowing the credit petitioned for by the G. B. R. Oil Corporation, concluded (40 B. T. A. 744):

> "The general purpose of section 26 (c)(2), it seems to us, is to give a credit where a dividend paid credit can not be secured. In other words, *the basic intent*

of Congress seems to have been to include in the provision only contracts which inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments. See *Paul and Mertens*, par. 32 A. 46, 1938 cumulative supplement.

Respondent in his brief cites no authority in support of his contention, but, after quoting the language of the assignments from petitioner to the bank, says:

'We are unable to find in these contracts or assignments any provision which expressly deals with the disposition of petitioner's earnings and profits of the taxable year.'

It is true, as we have already said, that the assignments in question do not expressly refer to 'earnings and profits' as such, but they certainly do require that all of petitioner's gross receipts from these properties be paid to the bank and that would certainly include 'all earnings and profits' from them.

Respondent says in his brief that petitioner 'could have declared a dividend out of its earnings and profits of the taxable year and paid same with borrowed money, notes, credits, or in stock.' Perhaps it could have done so. We do not consider that is a matter which we have to decide. Even assuming that it is so, we do not see where that fact affects the application of the credit provided by section 26 (c)(2). We sustain petitioner in this assignment of error."

The decision of *G. B. R. Oil Co. v. Commissioner*, 40 B. T. A. 738, was cited and followed by the District Court of the United States for the Eastern District of Virginia in *Chesapeake Ferry Co. v. Early* (Memo. Op.), 39-2 U. S. T. C. 10923, par. 9786.

The issue in *Michigan Silica Company v. Commissioner* (March 5, 1940), 41 B. T. A. 511, was whether the taxpayer, engaged in the production and sale of sand, was entitled to a credit under Section 26 (c)(2) of the 1936 Revenue Act because of a contract requiring it to pay to a trustee, under a bond indenture, 25 cents per ton for sand

sold, for the bond-sinking fund. The Board held that the requirement of 25 cents for each ton of sand produced and sold was one expressly dealing with the disposition of earnings and profits of the taxable year because this sinking fund provision in dealing with the taxpayer's gross receipts necessarily included the disposition of "earnings and profits."

The taxpayer made a payment in January 1937 for the sand produced and sold in December 1936. In allowing this payment as a credit in the determination of the 1936 tax the Board said at page 515:

> "Since it would be impossible to compute any monthly payment due the sinking fund here until after the close of the month, the contested credit shall include the payment for sand sold during December of the taxable year, 1936, even though that payment was not physically made until January 1937. This seems proper on the theory that such payment was made *as of* December, 1936."

The Board of Tax Appeals based its decision in the case at bar (*Strong Manufacturing Co. v. Commissioner*, 41 B. T. A. 1273, Taxpayer's Brief, Appendix B), on the above decision in *Michigan Silica Co. v. Commissioner*, 41 B. T. A. 511, stating:

> "On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, *Michigan*

Silica Co., 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled."

The practical and utter logic in the majority decision of the Board of Tax Appeals in the instant case seems irrefutable.

The minority opinion, on the contrary, simply adopts the narrow, technical view of the Commissioner's Brief in this case and holds that, because Taxpayer's note and mortgage, *in haec verba*, neither requires a payment or an irrevocable setting aside of profits during the taxable year of 1936 for the payment thereof, Taxpayer is entitled to no relief. Taxpayer submits that until the Commissioner and the minority opinion of the Board of Tax Appeals explain how Taxpayer could otherwise dispose of 40% of its 1936 profits, as they *accrued* than to set aside such profits for payment on its said indebtedness, without defaulting on its contract—which neither attempt to do—the position of the Commissioner and of the minority opinion of the Board in this case should find no acceptance with this Court.

The Board of Tax Appeals has alike given a reasonable and common-sense application of 26 (c)(1) of the 1936 Internal Revenue Act. *Prudential Fin. Corp. v. Commissioner* (1942), 46 B. T. A. 796; *Carolina-Florida Realty Co. v. Commissioner* (1942), 46 B. T. A. 777; *Paraport Theatre Leasing Corp. v. Commissioner* (April 8, 1941), 44 B. T. A. No. 14; *Kibly Steel Co. v. Commissioner* (May 24, 1940), 41 B. T. A. 1237; *Sutcliff Company v. Commissioner* (May 1, 1940), 41 B. T. A. 1009.

10. THE DECISIONS OF MOLONEY ELECTRIC CO v. COMMISSIONER (1941), 120 F. (2d) 617, AND ANTIETAM HOTEL CORP. v. COMMISSIONER (1941), 123 F. (2d) 274, RELIED ON BY THE COMMISSIONER, DISTINGUISHED FROM TAXPAYER'S CASE ON THE FACTS.

The case of *Moloney Electric Co. v. Commissioner* (1941), 120 F. (2d) 617 (C. C. A. 8th), is distinguished, on the facts, from the case at bar, in the following respects:

(1) The Trust Agreement relied on in that case did not require the setting aside of the required percentage of the earnings in the sinking fund for the retirement of bonds until the total annual profits for 1936 had been determined. Such determination was not required to be made before April 1, 1937. Actual payment of the profits to the Trustee were not required to be made until June 1, 1937. In the case at bar, Taxpayer was required to "apply" or, as has been shown, irrevocably set aside 40% of its 1936 profits as they accrued for the payment of its note and mortgage debt.

(2) While the taxpayer in the *Moloney* case had actually paid over $690,000 in retirement of all said bonds in 1936, there was no evidence in the record in that case to show what part of such amount was from the taxpayer's 1936 earnings or that any amount had been paid under the provisions of the indenture requiring the payment of 1936 profits on its bonded indebtedness or what the net earnings were at the times 1936 payments were made. In fact, the bonds redeemed in 1936 were taken up pursuant to an option in a totally unrelated article of the indenture. In the instant case, the evidence is undisputed that Taxpayer, The Strong Manufacturing Company, made its 1936 payments wholly out of 40% of its 1936 profits and in that year.*

In the case of *Antietam Hotel Corp. v. Commissioner* (1941) 123 F. (2d) 274 (C. C. A. 4th) there was no setting

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* Certiorari was denied in the *Moloney* case by this Court, November 10, 1941 and a rehearing denied January 12, 1942.

aside of the profits applicable to the taxpayer's indebtedness in the taxable year. In the Strong case, here at bar, the money was not only set aside—it was paid over to Taxpayer's creditor,—certainly an act of segregation of the most final nature. By way of *obiter dictum*, clearly unnecessary to the decision of the case, the court, in the *Antietam* case, held that the contract there involved did not, in terms, require the irrevocable setting aside of any portion of its profits and so the taxpayer, for this additional reason, was not entitled to the credit claimed. Section 26 (c)(2) does not require such provision of a contract to be explicit as a basis for claim thereunder. This holding was clearly unnecessary to decide the case on the facts there present and, in no event, binding as a precedent.

Taxpayer is convinced this Court will find nothing in the above decisions to impair the validity of the decisions of the court below or the Board of Tax Appeals or Taxpayer's contentions here made.

VIII. CONCLUSION.

Taxpayer believes the decisions of the United States Circuit Court of Appeals and of the Board of Tax Appeals were correct for the reasons that:

1. A clear intent was shown by the Reports of Hearings Before the Committees of Congress considering the 1936 Revenue Act, and by discussions in the sessions of Congress before its enactment, to tax only corporate profits earned in 1936 which were retained by the corporation, and to affirmatively grant a credit as to obligatory distributions of profits pursuant to a contract such as Taxpayer's.

2. The general title of the Revenue Act of 1936, declaring a purpose to equalize taxation, and the sub-title of Sections 13 (a) and 14 of said Act, imposing a tax on *undistributed* profits of corporations and of Sections 26 (c) and 26 (c)(2), granting a credit in respect to contracts re-

quiring the setting aside or payment of dividends on obligations created a presumption that Taxpayer's contract, which required the irrevocable setting aside of Taxpayer's 1936 profits to the extent needed to discharge its indebtedness, and the performance thereof, entitled Taxpayer to a credit under the facts in this case.

3. Taxpayer's contract complies with Section 26 (c)(2) of the 1936 Revenue Act in the respect that the controlling language of the provisions in issue contain words synonymous to the pertinent words therein contained.

4. Section 26 (c)(2) was intended to cover a class of contracts executed and delivered prior to its enactment and not formulated with the purpose of enjoying its benefits and,—generally,—to exempt all distributions of corporate profits, especially if paid under the express provisions of a contract to discharge a debt, and, therefore, Taxpayer's contract is in accord with every requirement of Section 26 (c)(2) construed according to such legislative intent and its performance entitles Taxpayer to the credit claimed.

5. The presumption raised by the facts in this case that Section 26 (c)(2) qualifies Taxpayer to a credit based on its setting aside and paying $46,500.00 of its 1936 profits in the taxable year 1936 to discharge its note and mortgage is aided by controlling rules of statutory interpretation and decisions requiring that the transaction in question be viewed in the light of common sense, standard business practice, and not according to a technical or strict construction, as contended by the Commissioner, and, finally that all doubts should be resolved in favor of Taxpayer.

Taxpayer, therefore, prays that the decisions of the Court and Board of Tax Appeals below should be affirmed, allowing a credit on its 1936 corporate undistributed profits surtax, based on the irrevocable setting aside and payment,

out of its 1936 profits and earnings, of $46,500.00 in discharge of its note and mortgage to The Central National Bank of Cleveland, in accordance with the specific provision of said note and mortgage and Section 26 (c)(2) of the 1936 Revenue Act, and that the deficiency assessment of the Commissioner levied in respect of said portion of Taxpayer's 1936 earnings and profits, be finally set aside and held for naught.

Respectfully submitted,

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October 15, 1942.

APPENDIX A.

Opinion of the United States Circuit Court of Appeals for the Sixth Circuit.

(124 F. (2d) 397.)

Decided December 9, 1941.

Before HAMILTON, MARTIN and MCALLISTER, Circuit Judges.

MCALLISTER, Circuit Judge. The Commissioner of Internal Revenue filed his petition for review of the decision of the Board of Tax Appeals that The Strong Manufacturing Company was entitled to a credit on its 1936 surtax on undistributed profits by virtue of Section 26 (c)(2) of the 1936 Revenue Act.

The above mentioned section of the act, in so far as here applicable, provided that credits on undistributed profits shall be allowed to a corporation to the extent that earnings and profits are required to be irrevocably set aside within the taxable year for the discharge of a debt, provided they are so required to be set aside by written contract executed by the corporation prior to May 1, 1936. The taxpayer, an Ohio corporation, purchased its plant and equipment from the Central United National Bank of Cleveland about April 15, 1932, for the sum of $50,000. The purchase price was evidenced by a note, secured by a mortgage executed by the taxpayer to the bank, providing for payment in eight installments of varying amounts, due on April 15, 1934, and on the same date of each year thereafter. Stipulations in the note set forth that the corporation could anticipate unpaid installments in whole or in part; and it was further provided in the note:

> "In addition The Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less

than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed."

The mortgage set forth:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid beginning on January 1st, One Thousand nine hundred thirty four, the Company shall apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note."

It was further provided that if the corporation defaulted, and such default continued for thirty days, the bank could declare the entire balance immediately due and payable; and no waiver of any default by the bank should affect any subsequent default.

In 1934, the taxpayer obtained from the bank a written extension on a then due installment of $2,000, principal, and $3,500, interest, on the note and mortgage. The extension was on the specific condition that it should not be considered a waiver of any subsequent defaults; and the bank did not waive or make any concession in respect to the covenants of the note and mortgage requiring the taxpayer to apply 40% of its net earnings in payment of the debt.

During 1936, the taxpayer made payments out of profits on the principal of the note, in various months, aggregating $46,500, whereupon the bank waived payment of a small amount of principal and some interest, and accepted such payments in full for the balance due on the note and mortgage. The taxpayer claimed that these aggregate pay-

ments on the note and mortgage, which it made in 1936, are entitled to credit on undistributed profits and that by virtue of the provisions of the act, it is not taxable thereupon.

The relevant provisions of the statute read:

> "In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—
>
> (c) Contracts Restricting Payment of Dividends.
>
> (2) Disposition of Profits of Taxable Years.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

Petitioner insists that the contract did not require that respondent irrevocably set aside a portion of its earnings of the taxable year within that year for the discharge of the debt; and that inasmuch as the contract did not come within the required terms of the statute, respondent is entitled to no credit for the payments made.

The question, therefore, before us for determination, is whether the payments made by the corporation upon its debt are taxable as undistributed profits, or whether it is entitled to credit on the basis of earnings and profits "irrevocably set aside within the taxable year for the discharge of a debt."

In brief, the statute allows a deduction on the tax in question where a contract requires a corporation to set aside irrevocably a portion of its profits within the taxable year for the payment of a debt. In this case, the contract of the corporation requires it to apply 40% of its net earnings for any calendar year to pay the balance of the debt, or a portion thereof, in that year. It is contended on behalf of the Commissioner that, because settlement on the debt could be made in the succeeding year, the contract does not require the irrevocable setting aside of such profits in the year in which they are earned. On the other hand, respondent corporation contends that, inasmuch as it is bound to "apply" its profits for the calendar year to the payment of the balance of the debt remaining unpaid in that year, this obligation comes within the requirement of the statute and constitutes a contract to set aside irrevocably a portion of its profits to the payment of a debt within a taxable year.

The phrase "set aside" has various meanings and connotations. One is "reserve"; and "reserve" is defined as "to keep back," "to retain," "to keep in store for future or special use," and "to retain or hold over to a future time"; "irrevocable" is defined as "incapable of being recalled or revoked." *Webster's New International Dictionary.* To sustain the respondent, we are required, however, to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain, or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax. Whether such a con-

struction can properly be given the statute, and whether the conclusion reasonably follows that respondent is entitled to credit, depends upon accepted rules of statutory construction.

The construction of the statute for which the Commissioner contends would forbid credits to any corporation whose business was such that it could not definitely ascertain its profits on the last day of the year; and this would exclude from such benefits all corporations that were obliged to take an inventory that could not be completed within the year. Obviously, the result would be to deny such credits to practically all manufacturing and merchandising corporations, and to admit only those financial companies whose earnings and profits are generally susceptible of immediate computation. This would be unjust. Payment of the high surtax would work an unusual hardship on a corporation that was required, under penalty of mortgage foreclosure, to pay such earnings on its mortgage debts. Furthermore, the result of sustaining the claim of the Commissioner would be to require payment of a surtax on undistributed profits where there were no undistributed profits, by reason of the fact that the earnings, under inexorable conditions of a contract, were required to be paid upon a debt. This would be unjust and result in a burden of an especial and unusual nature.

Where a particular construction of a statute will produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. *Constantine v. United States*, 75 Fed. (2d) 928, Aff., 296 U. S. 287. The strict letter must yield to the evident spirit and purpose when necessary to give effect to the intent of Congress; *Fleischmann Const. Co. v. United States, to use of Forsberg*, 270 U. S. 349; for a thing which is within the intention of the statutes is as much within the statute as if it were within the letter, and a thing which is within the letter of the statute is not within the statute,

unless it is within the intention of the maker; *Northwestern Mutual Life Insurance Co. v. Gridley*, 100 U. S. 614; and where the meaning is uncertain, a statute will be construed so as to avoid unnecessary hardship. *Burnet v. Guggenheim*, 288 U. S. 280. The duty of the court, being satisfied with the intention of the legislature, is to give effect thereto and not to defeat it by adhering too rigidly to the mere letter of the statute or to technical rules of construction. *Oates v. First National Bank*, 100 U. S. 239.

In the application of taxing statutes, substance and not form should control; *Sanborn v. Commissioner of Internal Revenue*, 88 Fed. (2d) 134, cer. den., 301 U. S. 700; and such laws should be construed and applied with a view of avoiding, as far as possible, unjust consequences. *Farmers Loan and Trust Co. v. State of Minnesota*, 280 U. S. 204.

In ascertaining the purpose of the legislature in enacting a statute, the court may examine its title and the legislative scheme or plan by which the object of the act is to be carried out; *United States v. Katz*, 271 U. S. 354; and the intention is to be ascertained, not by taking a word or clause from its setting and viewing it apart, but by considering it in connection with the context, general purpose of the statute, occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will. *Helvering v. Stockholms Enskilda Bank*, 293 U. S. 84. The purpose of all statutory construction is to give effect to the legislature's intention and, hence, no rule of strict construction, which will defeat a statute's purpose, can be applied to its bare language.

The general title of the 1936 Revenue Act sets forth its purpose to "provide revenue, equalize taxation, and for other purposes." The subtitle of Section 26 (c) of the act reads: "Contracts restricting payment of dividends," and the title of Sub-section 26 (c)(2) is: "Disposition of profits of taxable year." In the message of the President to Congress with respect to the enactment of the statute,

the provisions of which are under consideration, he directed attention to a form of tax for the purpose of removing inequalities in the tax system, and mentioned, in this regard, the accumulation of surplus in corporations and the freedom of such undistributed corporate income from surtax. *Message of President to Congress,* March 3, 1936. In the report of the Ways and Means Committee of the House of Representatives on the Revenue Bill of 1936, after quoting the message, the Committee stated that the President had requested Congress to raise additional revenue by some form of undistributed profits tax, and that the Committee recognized that the greatest defect in the system of taxation at that time lay in the fact that surtaxes on individuals were avoided by impounding income in corporate surpluses. It was further recommended that corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenue of the United States and to the detriment of the shareholders, *H. R. Rept. No. 2475, 74th Congress, Sec. Sess.* From these proceedings, the legislative intention and the general purpose of the act, are obvious. It was sought to prevent corporations from accumulating tax free surplus arising out of their failure to distribute the earnings to shareholders, with the result that the Government could not tax such individuals. The headings in the statute, above referred to, indicate the intent to grant credit on surtax imposed on undistributed profits to the extent that such profits were not declared as dividends by reason of a contract requiring a different disposition of such profits.

It is necessary to keep in mind that taxation is an intensely practical matter and the substance of the thing done, and not the form it takes, must govern. *Commissioner of Internal Revenue v. Ashland Oil and R. Co.,* 99 Fed. (2d) 588 (C. C. A. 6); and that common sense interpretation is the safest rule to follow in the administration

of income tax laws. "Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes, men should measure both by ordinary, every-day business standards." *Rhodes v. Commissioner of Internal Revenue*, 100 Fed. (2d) 966, 969 (C. C. A. 6).

With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, accounting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation, here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.

We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to "apply" 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26 (c)(2) of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit.

That the profits, which were required to be applied to the indebtedness, could not be computed until after the taxable year, casts no doubt upon the conformity of the contract to the requirements of the statute. Where the law requires debts to be charged off within the taxable year, in order to receive deductions, the statutory language is construed to allow deductions for debts *physically* charged off in the first months of the succeeding year, in recognition of practical business necessities; and it is held that Con-

gress did not intend that there should be any essential departure from the usual course of business in making book entries in order to comply with tax laws. *Hamlen v. Welch*, 116 Fed. (2d) 413 (C. C. A. 1); *Kentucky Rock Asphalt Co. v. Helburn*, 20 Fed. Supp. 364, Aff., 108 Fed. (2d) 779 (C. C. A. 6). Like principles are applicable to the ascertainment of profits, and credit for applications thereof on indebtedness.

The claim is advanced that because the duty to make certain regular stipulated payments did not, by contract, depend on the existence of earnings, therefore, the taxpayer is not entitled to credit for such payments on the indebtedness. But the taxpayer is only seeking credit for that amount of profits which, in accordance with the contract, it claims it irrevocably set aside for payment of the debt. If the contract, with respect to the setting aside of such profits, conforms to the requirement of the statute, it is immaterial that the portion of profits so set aside for the indebtedness, exceeded the stipulated sum which was required to be paid, regardless of profits. That such required payment was included in the percentage of profits required to be set aside, has no bearing upon the right to credit.

We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp. v. Commissioner of Internal Revenue*, ... Fed. (2d) .... (C. C. A. 4) (decided November 10, 1941), it was held "that as an indispensable condition precedent to the allowance of the credit, the contract must in terms require that a part of the earnings and profits of the taxable year be * * * irrevocably set aside within the taxable year." We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, *in terms*. With regard to the case of *Helvering v. Moloney Electric Co.*, 120 Fed. (2d) 617 (C. C. A. 8), in which it was held that the taxpayer was

not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless.

In accordance with the foregoing, the decision of the Board of Tax Appeals is affirmed.

APPENDIX B.

Findings of Fact and Opinion of the United States Board of Tax Appeals.

(41 B. T. A. 1273.)

Docket No. 95626. Promulgated May 29, 1940.

Contract requiring application of a portion of petitioner's earnings and profits for the taxable year against indebtedness incurred prior to 1936, *held*, to require irrevocable setting aside of such portion and to entitle petitioner to a credit for purposes of the undistributed profits tax to the extent that such payment was actually made in the taxable year. Revenue Act of 1936, sec. 26 (c) (2).

Arthur Morgan, Esq., Raymond S. Powers, Esq., and *Sidney J. Collins, C. P. A.*, for the petitioner.

DeWitt M. Evans, Esq., Paul A. Sebastian, Esq., and *Stanley B. Pierson, Esq.*, for the respondent.

This proceeding was brought for a redetermination of a deficiency in petitioner's income and excess profits taxes in the amounts of $14,776.89 and $548.37, respectively, for the year 1936.

The issues presented by the pleadings are: (1) Whether petitioner is entitled to a credit under the provisions of Section 26 (c) (2) of the Revenue Act of 1936 in computing the surtax on its undistributed profits; and (2) whether petitioner was entitled to certain deductions for expenditures for repairs and replacements.

FINDINGS OF FACT.

Petitioner, an Ohio corporation organized in 1932, has its principal offices at Sebring, Ohio, and is engaged in the manufacture of enamelware.

On or about April 15, 1932, petitioner purchased its plant and equipment from the Central United National Bank, Cleveland, Ohio, trustee for the bondholders of the Sebring Manufacturing Corporation. The purchase price was $50,000, for which petitioner on April 15, 1932, exe-

cuted a note secured by a mortgage to the Central United National Bank (hereinafter referred to as the bank).

The note was as follows:

For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$ 2,000	on April 15, 1934
3,000	on April 15, 1935
5,000	on April 15, 1936
6,000	on April 15, 1937
7,000	on April 15, 1938
8,000	on April 15, 1939
9,000	on April 15, 1940
10,000	on April 15, 1941

Any unpaid portion of the said principal sum shall bear interest from April 15, 1932 at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price, provided

that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof.

On the same date petitioner executed the mortgage securing the note. Its pertinent provisions are as follows:

ARTICLE I.

Anticipation of Payments upon Note.

(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term "net earnings" as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured re-

main unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment, be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note.

* * * * *

ARTICLE IV.

Remedies on Default.

(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1 hereof, and such default shall have continued for thirty (30) days; * * * the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. * * *

(2) No waiver by the Bank of any such default by the Company, whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom.

* * * * * *

The provision of article I, paragraph 1, above quoted, with reference to petitioner's obligation to apply 40 percent of the earnings of each year on the note and mortgage, was required by the bank in order that in prosperous years petitioner would devote a portion of its profits to the payment of the mortgage, and the bank would be protected to this extent should the company later become involved in difficulties.

On May 28, 1934, petitioner and the bank executed an agreement wherein it was recited that the company was not able to pay the principal installment of $2,000 due April 15, 1934, and was in default in payment of the interest in the approximate amount of $3,500. By the agreement the bank granted an extension to April 15, 1941, for the payment of the principal installment and an extension to April 15, 1935, for $3,000 of the delinquent interest. The extension on the principal payment was "with the understanding, however, that such extension shall not be construed as a waiver of any subsequent defaults."

There was no modification of the provision requiring petitioner to apply 40 percent of its net earnings in payment of the principal and interest.

Petitioner's income and excess profits tax return for the year 1936 reported a net income of $126,786.04.

On January 1, 1936, petitioner owed $47,000 on its indebtedness on the note and mortgage. During the year 1936 it made payments on the principal sum on the dates and in the amounts as follows:

2/15/36	$2,500	6/29/36	$1,000	9/15/36	$ 500
4/15/36	2,500	7/14/36	500	10/15/36	34,000
5/15/36	500	7/31/36	1,000		
5/29/36	1,000	8/14/36	500	Total	46,500
6/15/36	500	8/31/36	2,000		

The bank accepted the $46,500 payment in 1936 in full satisfaction of the $47,000 due, and also forgave $117.50 interest.

By September 30, 1936, petitioner's approximate profits were $86,000, and it had orders on its books in that month of approximately $100,000. Since it appeared that petitioner's profits would be such that 40 percent thereof would be in excess of the amount required to discharge the mortgage in full, it was decided to make the payment at that time. It would not have been possible to determine on January 1, 1937, the profits of petitioner for 1936 with complete accuracy.

The parties have stipulated, and we accordingly find, that petitioner should be allowed deduction of $2,215.88 as expenses for repairs and replacements during the taxable year.

OPINION.

OPPER: The present issue calls for the application to the foregoing facts of the provisions of Section 26 (c) (2) of Revenue Act of 1936[1] entitling a corporation to a

---

[1] SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * *

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

* * * * * *

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable

"credit" against the "undistributed profits tax" if it complies with certain requirements.

On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the "application" to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract "as of" the taxable year, *Michigan Silica Co.*, 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled.

Repair and replacement expenses may be deducted as stipulated.

Reviewed by the Board.

Decision will be entered under Rule 50.

---

year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

BLACK, dissenting: I can readily agree that from the standpoint of reason and logic there would seem just as good reason for Congress to grant a credit in determining surtax on undistributed profits to a corporation situated as was the petitioner in the instant case as there was to other corporations which had contracts of indebtedness which come more precisely within the terms of the statute (Sec. 26 (c) (2), 1936 Act). But it is the precise statute which we have to construe and I do not see how it can be so broadly construed as to admit a credit to petitioner under the facts as they have been found.

The statute in question, which has been set out in the majority opinion, seems to provide four things as conditions precedent to securing the credit. These are:

(1) There must exist a written contract executed by the corporation prior to May 1, 1936. Here there was a written contract executed prior to May 1, 1936, and so that condition is fulfilled.

(2) This contract must deal with the earnings and profits of the taxable year. The contract in question does deal with 40 per cent of the net earnings of petitioner for the taxable year, so that condition is met.

(3) The contract must *require* the payment or the irrevocable setting aside of the earnings in question *during* the taxable year for the discharge of the debt in question. In the instant case it is plain that the contract does not require that the 40 percent of the net earnings be paid on the indebtedness *during* the taxable year. On the contrary, petitioner was granted until April 15 of the following year in which to make payment. So it seems clear to me that, in so far as payment is concerned, the contract in question does not meet the terms of the statute. But the statute grants the credit if there is a requirement in the contract that the portion of earnings in question be "*irrevocably set aside*" during the taxable year for the dis-

charge of the debt. I see nothing in the contract which required the taxpayer to irrevocably set aside any of its earnings of 1936 prior to the granted time of payment which was April 15, 1937. So, in the view I take, one of the conditions precedent is not met. I can not take the view expressed in the majority opinion that when the statute says that the contract must *require* either payment or irrevocably setting aside of earnings *within* the taxable year it means "as of" the taxable year. I see no warrant for such construction.

(4) The credit granted, when all conditions have been fulfilled, is the amount which "has been so paid or set aside." In the instant case there has been a payment all right on the indebtedness to the full extent of the credit claimed, but, as I view it, in the absence of a requirement in the contract that these earnings be paid or irrevocably set aside in 1936, their actual payment in 1936 becomes immaterial.

Congress in the Revenue Act of 1938 wrote a provision which seems to be broad enough to permit a credit under the facts and circumstances of the instant case. See Sec. 27 (a) (4), Revenue Act of 1938. This section, however, has no retroactive application and, for reasons which I have already stated, I do not believe that the credit which petitioner claims can be granted under the terms of the 1936 Act. I think the Commissioner should be sustained and I, therefore, respectfully dissent from the majority opinion.

MELLOTT and KERN agree with this dissent.

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In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. 42.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

WARREN TOOL CORPORATION,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

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In the Supreme Court of the United States

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No. 42.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

WARREN TOOL CORPORATION,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

I. OPINION BELOW.

The opinion of the Board of Tax Appeals (Warren,[1] R. 22-23) is not reported. The memorandum opinion of the Sixth Circuit Court of Appeals is reported at 124 F. (2d) 360.

II. JURISDICTION.

The decree of the Circuit Court of Appeals was entered December 9, 1941. (R. 31.) The petition for the writ of certiorari was filed March 5, 1942 and granted April 6, 1942. The jurisdiction of this Court is invoked by the petitioner under Section 240(a) of the Judicial Code as Amended by the Act of February 13, 1925.

---

[1] This case, *Helvering v. Warren Tool Corp.*, No. 42, has been placed by the Court on the Summary Docket with *Helvering v. Ohio Leather*, No. 40, and *Helvering v. Strong Mfg. Co.*, No. 41, which are, in so far as the major legal questions, substantially similar cases. The petitioner has filed one brief for all three cases. References in this, the brief of the respondent in No. 42, to the record (R. ...) are to the record (top paging) in No. 42, the Warren Tool Corporation case. References to other records are thus—(Ohio, R. ....) for No. 40 and (Strong, R. ....) for No. 41.

III. STATEMENT OF THE CASE.

A. Nature of Proceedings.

The respondent, Warren Tool Corporation (hereinafter sometimes referred to as "the taxpayer"), appealed to the United States Board of Tax Appeals from a determination by the petitioner, the Commissioner of Internal Revenue (hereinafter sometimes referred to as "the Commissioner") that the taxpayer owed additional income taxes for the years 1936 and 1937 in the amounts of $3,037.25 and $3,193.53, respectively. The cases were consolidated for hearing. Items relating to depreciation and development expenses for the year 1936 and items relating to reserve for quantity discounts, capital stock tax and other taxes for the year 1937 were removed from consideration in the cause by the taxpayer's abandonment. (Opinion Board of Tax Appeals, Record 23.) The Commissioner contended that there still remained deficiencies of income tax (i.e. surtax on undistributed profits) in the amounts of $1,587.37 for the year 1936 and $2,076.30 for the year 1937. The Board of Tax Appeals, in an opinion not officially reported but set forth in the Record, pages 17 to 23, held that the Commissioner erred in determining said additional deficiencies. The Circuit Court of Appeals affirmed the Board of Tax Appeals.

B. Question Presented.

The tax involved is the one imposed by Section 14(b) of the Revenue Act of 1936 and is measured by the corporation's "undistributed net income" which is defined in Section 14(a)(2) as "the adjusted net income minus the sum of the dividends paid credit provided in Section 27 and the credit provided in Section 26(c), relating to contracts restricting dividends."

The controversy is over the allowance of credits under Section 26(c)(2) (set out in full under Statutes Involved, *infra*) for sinking fund payments required under a trust

indenture which compelled the taxpayer to pay to the Trustee on the first day of each April a sum of money equal to 25% of its net earnings for the calendar year next preceding. The Commissioner contends that the taxpayer is not entitled to the credits because the twenty-five per cent of the net earnings were not payable until the year following the taxable year and that the taxpayer can not claim a credit for irrevocably setting aside these funds because it was not expressly and explicitly required to do so by any particular language in the indenture. The taxpayer contends that it is entitled to the credits because it was required by the terms of the indenture to irrevocably set aside within the taxable year these amounts, and because upon consideration of its estimated net earnings toward the end of each taxable year it did so irrevocably set aside—by actually paying the amounts claimed as deductions. The taxpayer claims that the requirement to irrevocably set aside funds need not be express.

C. Statutes and Regulations Involved.

The Revenue Act of 1936; 74th Congress, Sess. II, Ch. 690; 49 Stat. 1648.

"Sec. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) Definitions.—As used in this title—

(1) The term 'adjusted net income' means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26(d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26(e).

(2) The term 'undistributed net income' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26(c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income."

"Sec. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * *

(c) *Contracts Restricting Payment of Dividends—*

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to

one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

"SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the con-

ditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

* * * * *

(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage

of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. A contractual provision, however, shall not be considered as not expressly dealing with the disposition of earnings and profits of the taxable year merely because it deals with such earnings and profits in terms of "net income," "net earnings," or "net profits."

D. Statement of Facts.

The taxpayer on November 1, 1932 executed a first mortgage and deed of trust to The Cleveland Trust Company (hereinafter called "the Trustee") securing bonds issued on that date in the amount of $50,000. Between November 1, 1932 and January 1, 1935 $18,000 more bonds were issued, and on January 1, 1935 $68,000 of the bonds were outstanding. The bonds bore interest at six per cent per annum. (Item 1 of Stipulation Correcting Errors in Printed Transcript[1] and R. 17 and 18.[2])

The sinking fund provision in the mortgage provided in part:

"ARTICLE IV.

Sinking Fund.

Section 1. For the purpose of creating the sinking fund for the redemption of the bonds issued hereunder, the Company hereby agrees to pay to the Trustee on or before the 1st day of April, 1935, and on or before the first day of April of each year thereafter to and including April 1, 1942, a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding. * * * The Company may, in lieu of depositing cash in whole or in part, purchase bonds

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[1] This typewritten stipulation executed by both parties by their respective attorneys was filed in this Court on July 27, 1942.

[2] All references "R" hereinafter in the Statement of Facts are to the Memorandum Findings of Fact and Opinion of the Board of Tax Appeals as found in the Printed Transcript filed in this Court, except where otherwise specifically indicated.

issued hereunder at a price not exceeding the redemption price thereof as fixed by the provisions of Article V hereof, and deliver such bonds to the Trustee for credit against said sinking fund obligations to the extent of the purchase price (excluding the accrued interest) paid therefor by the Company. * * * Prior to the first day of April in each year above mentioned, the Company shall also file with such Trustee a statement sworn to by one of such officers showing the amount of the Company's net earnings for the preceding calendar year computed in the manner hereinbefore provided and duly certified by such accountant or accountants." (R. 18, and Item 2 of Stipulation Correcting Errors in Printed Transcript.)

For 1934 the petitioner had no net earnings and so advised the Trustee by letter dated March 30, 1935. (R. 18.)

The taxpayer's certified net earnings for the year 1935, computed in the manner required by the sinking fund provision of the indenture amounted to $15,020.84 and it owed the Trustee $3,755.21 for the sinking fund. (R. 18.)

Considering the sinking fund requirement, the taxpayer purchased on or about March 23, 1936, out of its net earnings for 1935, from the holders thereof, $5,500 of its first mortgage bonds and on that date delivered them to the Trustee. The Trustee cancelled, discharged and cremated the bonds and applied them against the sinking fund requirements, which amounted to $3,755.21, as shown above. (R. 18.)

On or about December 3, 1936 the taxpayer's accountant estimated that the taxpayer's net earnings, under the above quoted section of the mortgage, for the calendar year 1936, would be about $50,000. It delivered to the Trustee $12,500 of its first mortgage bonds, for which it had paid $12,755. These bonds had been purchased from their holders between November 9, 1936 and December 3, 1936. These bonds were delivered in consideration of the sinking fund requirement and were cancelled and cremated by the Trustee. (R. 18-19.)

On February 10, 1937 the taxpayer certified to the Trustee that its net earnings for the calendar year ending December 31, 1936, were $44,068.90 and therefore the payment owed to the Trustee was $11,017.22, which had been satisfied on December 3, 1936 as above related. (R. 19.)

On or about December 2, 1937, the taxpayer's accountant estimated that its net earnings under the mortgage for the calendar year 1937 would be about $50,000. It delivered to the Trustee $10,000 of its first mortgage bonds, for which it had paid $10,000. On or about December 1, 1937, these bonds had been redelivered to the taxpayer by The Second National Bank of Warren which had held the bonds as collateral security for a loan to the taxpayer, upon the taxpayer paying the bank a $10,000 note which was due December 1, 1937. These bonds were cancelled and cremated by the Trustee. (R. 21.)

On or about December 28, 1937, the taxpayer, upon reconsideration of the matter, estimated that its net earnings for the calendar year 1937 would be about $52,000, based on the accountant's revised report. It delivered to the Trustee $4,000 more of its first mortgage bonds on December 28, 1937, for which it had paid $4,000. These bonds had been redelivered to the taxpayer by The Second National Bank of Warren on or about December 28, 1937, upon the taxpayer paying that bank $4,000 on a $10,000 note which was not due until December 1, 1938. These bonds were cancelled and cremated by the Trustee. (R. 22.)

The net earnings of the taxpayer for the year 1937 were thereafter determined by its accountant to be $52,214.10, and therefore of the $14,000 of its first mortgage bonds deposited in December, 1937, $13,053.52 were one-fourth of the net earnings. (R. 22.)

In December 1938, the taxpayer pursued the same method of operation as described above for the years 1936 and 1937. (R. 22.)

During the taxable years in question the taxpayer made its income tax returns upon an accrual basis. (R. 22.)

IV. THE ARGUMENT.

Summary of the Argument.

Both the Sixth Circuit Court of Appeals and the Board of Tax Appeals sustained the taxpayer's position that in the determination of its adjusted net income, as defined in Section 14(a)(2) of the Revenue Act of 1936 for the computation of its undistributed profits tax the sums taken from its current earnings and profits (up to twenty-five per cent of its net income as determined in accordance with the provisions of the sinking fund agreement) used to purchase bonds which it then deposited for discharge and cancellation with the trustee during the taxable year for the purpose of meeting the sinking fund requirements of that year, were sums constituting allowable credits under Section 26(c)(2) of the Act. The Board in its memorandum opinion followed its decision in *Strong Manufacturing Company*, 41 B. T. A. 1273. Likewise the Circuit Court of Appeals in its memorandum opinion, 124 F. (2d) 397 (R. 31), in accordance with its opinion in *Commissioner v. Strong Manufacturing Co.*, 124 F. (2d) 360. A similar result was reached by the Board in *The Ohio Leather Company*, which was likewise affirmed by the Sixth Circuit Court of Appeals, 124 F. (2d) 397 in accordance with its opinion in *Commissioner v. Strong Manufacturing Co.*

The respondent contends that under the facts as set forth above, the Board of Tax Appeals and the Circuit Court of Appeals properly allowed the claimed credits for the following reasons:

1. It was the basic intention of Congress to force all available current earnings of corporations to go through the tax mill in the hands of shareholders. To accomplish this after it levied a normal tax it taxed "undistributed income" at rates which were progressively higher as the percentage of undistributed income, compared with total income increased. In determining undistributed profits

there were of course deducted the earnings actually distributed in the form of dividends. Also recognizing that some corporations were under obligations which prevented them from making these distributions it gave credit for sums withheld under "Contracts Restricting Payment of Dividends" and classified these into classes—those which were (1) "Prohibition on Payment of Dividends" and (2) those requiring a "Disposition of profits of taxable year." (Thus Congress entitled Section 26(c) and its two subsections—(1) and (2).

Toward the close of each taxable year the taxpayer made payments to a sinking fund in obedience to a provision of a trust indenture which required that the taxpayer pay to the trustee on April 1 of each year an amount equal to 25% of its net earnings for the preceding year. The amounts paid in December of each year were 25% of the estimated earnings and the amounts claimed are 25% of the actual earnings. Taxpayer does not base its claim upon the fact that it "paid." Taxpayer paid at the time it did because that was the best evidence of its having actually "irrevocably set aside" these sums. Taxpayer might have paid over to a trustee or even set up a special account in a bank or taken any other step but it was essential that taxpayer take a definitive step which would constitute an irrevocable setting aside because the credit is limited "to the extent that such amount has been so paid or set aside."

It is the taxpayer's contention that under the trust indenture it was required to irrevocably set aside within the tax year these sums from its earnings for that year within the meaning of Section 26(c)(2) of the Revenue Act as that section stands alone or, as read in the light of Congressional intent and aim.

The taxpayer also contends that the Commissioner's interpretation of the section ignores certain of its words and phrases and inserts matter which is not there and accordingly such interpretation is erroneous.

A. The sinking fund agreement was a contract to "irrevocably set aside within the taxable year for the discharge of a debt" the sums—up to twenty-five per cent of the net earnings—actually set aside.

There are a number of requirements which must be met before a taxpayer may be granted a credit for having irrevocably set aside sums, thus it must have been pursuant to a contract:

(a) in writing;

(b) executed by the taxpayer before May 1, 1936;

(c) expressly dealing with the disposition of earnings and profits of the taxable year; and

(d) requiring the paying or irrevocably setting aside for the payment of a debt within the taxable year of the sums claimed as a credit.

The Commissioner concedes the existence of the first three requisites and only challenges the existence of the fourth.

The taxpayer contends that the sinking fund agreement to *pay* on April 1, a sum of money equal to twenty-five per cent of its net earnings constituted an agreement to "irrevocably set aside" such earnings as they were earned, i.e., "within the taxable year." The actual payment was the practical way of evidencing this setting aside. A transfer to another trustee, other than trustee under the indenture, would have been equally effective. The sinking fund covenant imposed a fiduciary duty upon the taxpayer. The Commissioner makes the argument that the taxpayer was free to use until April 1 for its own purposes these funds for the purchase of new equipment, investment or other "appropriate" purposes, except, the Commissioner does concede, that the taxpayer was under an obligation "imposed by operation of law, to refrain from such a dissipation or distribution of the specified percentage of net earnings which would put the percentage beyond the reach of the trustees or creditors." (Pet. Br. p. 18.) This attempt

to introduce a class of permitted and non-permitted uses indicates, we believe, as well as anything we could say, the weakness of the Commissioner's position. For either there was merely a debt or there was a complete fiduciary obligation. This is practically like saying that a trustee may use for his own purposes trust funds as long as he is careful to put the money into assets upon which the beneficiaries may levy after they get a judgment against the trustee. Here under the trust indenture the taxpayer was obligated to pay an amount[1] equal to 25% of its net earnings in cash (or in bonds) to the trustee and the taxpayer could not use the money for its own purposes merely on the excuse that it was still keeping it available for the trustee and the creditors.

In *Morse v. Bay State Gas Co. of Delaware*, 91 Fed. 938, an equity suit on income bonds (and the bonds in the case now before this Court have a dual obligation on the taxpayer, one to pay at a day certain, the other to set aside for payment a percentage of net earnings) Circuit Judge Dallas, in overruling a demurrer which had raised the question of the right of the holders to bring an action in equity and holding that a court of equity had cognizance of the action, said:

> "• • • But, again, it is contended that no duty was assumed with which a court of equity is competent to deal; that what is set up amounts to but a breach of contract. I cannot assent to this. Those who took these bonds did not, as has been pointed out, accept mere promises to pay. They, of course, relied, and had a right to rely, upon the fidelity of the corporation for the production, protection and application of net earnings, and by its necessarily implied undertaking to

[1] Any doubt that this must be considered a trust for the purpose of this statute would be dispelled by the provision of Section 26(c)(2) that: "• • • For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits."

exercise good faith in this regard the corporation assumed an obligation which was fiduciary in its nature, and which, therefore, is of equitable cognizance. * * *" 91 Fed. 938 at 939.

Corresponding to the fiduciary duty thus imposed on the taxpayer, there was an equitable interest in the income vested in the trustee for the benefit of the bondholders. The right to have a portion of income devoted to the sinking fund was a separate right in addition to and independent of the right to have the bonds paid at maturity in 1942. (*New York Trust Co. v. Michigan Traction Co.*, 193 F. 175 (Dist. Ct. Mich. 1912).) And therefore there was created an equitable lien. In *Barnes v. Alexander*, 232 U. S. 117 (1914), Barnes, an attorney employed on a contingent fee of one-fourth, promised Alexander and Street one-third of this one-fourth if they, Alexander and Street, would attend to the case. The court held that this promise created a lien upon the fund the instant it was received by Barnes because even though originally words of contract rather than conveyance had been used:

"the important thing is not whether they used the present or the future tense but the scope of the contract. In this case it aimed only at the fund. * * * the moment the fund was received the contract attached to it as if made at that moment. It is an ancient principle even of the common law that words of covenant may be construed as a grant when they concern a present right [citing cases]. And it is one of the familiar rules of equity that a contract to convey a specified object even before it is acquired will make the contractor a trustee as soon as he gets a title to the thing. [Citing cases.]" 232 U. S. 117 at 121.

In another contingent fee case, *Geddes v. Reeves Coal & Dock Co.*, 20 Fed. (2d) 48 (C. C. A. 8 (1927)) the court said:

"The general principles, rules and practice in equity applicable to this case have been stated by Pomeroy

and his statement of them has been adopted and confirmed by repeated decisions of the Supreme Court and of other courts. He wrote: 'Every express executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, or fund, therein described or identified, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforcible against the property in the hands not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees and purchasers or encumbrancers with notice.' 3 *Pomeroy's Equity Jurisprudence*, § 1235.

"'It is well settled that an agreement to charge, or to assign, or to give security upon, or to affect property not yet in existence * * * or property to be acquired by him in the future * * * does constitute an equitable lien upon the property so existing or acquired at a subsequent time, which is enforced in the same manner and against the same parties as a lien upon specific things existing and owned by the contracting party at the date of the contract.' 3 *Pomeroy's Equity Jurisprudence*, § 1236." 20 F. (2) 48 at 50.

In *Klaustermeyer v. The Cleveland Trust Co., Assignee*, 89 Ohio St. 142, 105 N. E. 278 (1913), Klaustermeyer was a director of The Euclid Avenue Trust Company, which was in financial difficulty. He and others agreed each to loan the bank $5,000.00 upon the condition that they each should be given security for the deposit from the collateral securities owned by and in the possession of the bank. Klaustermeyer did make the loan but did not receive any securities as collateral. Nor did the bank at any time segregate any securities for him. Three days after the loan the bank made an assignment for the benefit of its creditors. In holding that Klaustermeyer had an equitable lien on the assets of the bank (no rights of third parties having intervened) the Ohio Supreme Court said:

"Now, one of the fundamental maxims of equity is, '*equity regards as done that which ought to be done.*'

" 'The broad meaning of this maxim is that where an obligation rests upon a person to perform an act equity will treat the person in whose favor the act should be performed as clothed with the same interest and entitled to the same rights as if the act were actually performed. It is closely connected with and probably derived from the principle of regarding intent and substance rather than form. * * * The principle also lends its force to the establishment of liens and charges which could not be sustained at law, and to working out justice by fixing *rights as of the time when the obligation first accrued,* rather than according to circumstances subsequently arising.' 16 *Cyc.* 135." (Italics the court's.) 89 Ohio St. 142 at 147, 105 N. E. at 280.

That the trustee in the present case could restrain the dissipation of the earnings of the corporation is indicated by the decision in *Marine Midland Trust Co. v. Alleghany Corporation,* 28 F. Supp. 680 (Dist. Ct. N. Y. 1939). In that case a preliminary injunction was granted the trustee prohibiting the defendant obligor from disposing of certain assets on the ground that the "reasonable interpretation" of the trust indenture together with the preliminary letter and offering circular was that the defendant had promised to maintain as collateral security a deposit of securities in an amount of not less than 150% of the bonds outstanding.

From the foregoing it is clear, we believe, that the taxpayer was under a duty to "irrevocably set aside" the sums that it did use for the purchase of the bonds within the taxable years and therefore to the extent that these sums constituted twenty-five per cent of its net earnings it is entitled to a credit under 26(c)(2) of the Revenue Act of 1936 in determining its undistributed net income as defined in Section 14(a)(2).

B. Where a corporation is required to devote a portion of its net earnings for a taxable year to satisfy a sinking fund obligation entered into prior to May 1, 1936, it is clear under the statute and Congress manifestly intended that the amounts thus irrevocably set aside must, to the extent they were required to be set aside, be deducted from its adjusted net income in order to determine its undistributed income subject to surtax. Therefore the credit is properly claimed in this case because the statute standing alone, when every part of it is considered, allows the credit.

The taxpayer contends that even construing both the statute and the indenture in the most confined way it is entitled to the credits, but if there be any doubt as to this, it is entitled to a liberal construction of the statute and under such construction the allowance of the credit is manifestly proper.

Obviously even under a strict construction of Section 26(c)(2) of the Revenue Act of 1936 all parts of the section must be considered. In *Ex parte Public Bank*, 278 U. S. 101 (1928) the Supreme Court said at page 104:

> "• • • In other words, we are asked to ignore the quoted words and read the section as though they were not there.
>
> But we are not at liberty thus to deny effect to a part of a statute. No rule of statutory construction has been more definitely stated or more often repeated than the cardinal rule that 'significance and effect shall, if possible, be accorded to every word. As early as in *Bacon's Abridgement*, sect. 2, it was said that "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant."' *Market Co. v. Hoffman*, 101 U. S. 112, 115. • • •"

The Commissioner has totally disregarded this fundamental principle when, in his brief in this Court, he has insisted that the credit for sinking funds should be denied because the sums were not "payable" until the early part of the year following the taxable year in which the earn-

ings and profits[1] accrued and therefore the setting aside was not required within the taxable year. The statute reads in full as follows:

> "(2) *Disposition of Profits of Taxable Year*—An amount equal to the *portion* of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be *irrevocably set aside within the taxable year for the discharge of a debt*; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a *percentage* of earnings and profits shall be considered a requirement to pay or set aside such *percentage* of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936" (Italics ours.)

The Commissioner wholly disregards the italicized parts.

The taxpayer contends that the use of the phrase "irrevocably set aside for the discharge of a debt" contemplates situations where, as here, the actual date of payment is postponed to a later date or event and the use of the phrase "portion of the earnings and profits of the taxable year" together with the express reference to requirements for setting aside a "percentage" contemplate situations where, as here, the amounts allowable as deductions are parts from (i.e. "portions of" or "percentages of") an *entire year's* net earnings.

The fact that Congress provided for cases where the "payment" of the debt was to be postponed until after the

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[1] The indenture uses the phrase "net earnings." (R. 18.) This by the Treasury Department's Regulations 94 Relating to the Income Tax under the Revenue Act of 1936 § 26(2)(c) is the equivalent of "earnings and profits." The Commissioner does not contend otherwise.

taxable year is clearly shown by a consideration of the differences of language in the two grounds for credits under Section 26(c)(2), *viz.*: "The portion of the earnings and which is required * * * [1] to be paid within the taxable year *in* discharge of a debt, or [2] to be irrevocably set aside within the taxable year *for* the discharge of a debt * * *." (Italics ours.) The word "for" under [2] is used in the sense of "for the future," as contrasted with the word "in" under [1] used in the sense of "in the present." Clearly the phrase "within the taxable year" as used in the second ground modifies "set aside" rather than "for the discharge of a debt." Otherwise there would be no purpose in having [2] at all. In other words, the requirement is that the setting aside take place in the taxable year and it is sufficient if it is an irrevocable setting aside to take care of the discharge of a debt at some later date.

The legislative meaning as expressed in its plain words (*Helvering v. Northwest Steel Mills*, 311 U. S. 46, 49 (1940)) was to grant a credit for a setting aside measured by an *entire year's* earnings and profits. First Congress designates a "*portion* of the earnings and profits of the taxable year * * *" then it provides "For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a *percentage of earnings and profits* shall be considered a requirement to pay or set aside such *percentage* of earnings and profits."

In *Helvering v. Northwest Steel Mills*, 311 U. S. 46, this Court held that a corporation's charter taken with a law of the state of incorporation prohibiting dividend payments, except from surplus, did not constitute a "contract" within the meaning of Section 26(c)(1) of the Revenue Act of 1936, which grants a credit for sums which the taxpayer could not distribute as dividends "without violating a provision of a written contract." The taxpayer made the further argument that the tax, as applied

to it, was unconstitutional as a confiscation of property without Due Process because the tax was imposed only on undistributed income, and it claimed it could have no undistributed net income as long as it had an existing deficit.

In reply, this Court said:

> "• • • But the surtax here is imposed upon the undistributed net income of the corporation 'for each taxable year.' [Obviously, this Court was here quoting from Section 14(b) *Imposition of Tax* set out in full in *I. Statutes and Regulations Involved, supra.*] It is true that the surtax is imposed upon the annual income only if it is not distributed, but this does not serve to make it anything other than a true tax on income within the meaning of the Sixteenth Amendment. Nor is it true, as respondent urges, that because there might be an impairment of the capital stock, the tax on the current annual profit would be the equivalent of a tax upon capital. Whether there was an impairment of the capital stock or not, the tax here under consideration was imposed on profits earned during a definite period —a tax year—and therefore on profits constituting income within the meaning of the Sixteenth Amendment." 311 U. S. 46 at 53.

The words "portion" and "percentage" by definition and by common usage mean a part of a whole. Congress taxed the entire (i.e. twelve months) undistributed net earnings. It is not only common knowledge but also specifically proved in the *Strong Manufacturing Company* case (No. 41) that the ascertainment of net earnings of manufacturing is impossible of ascertainment until after close of the taxable year. Thus Article 22 (c)-1 of the Treasury Department Regulations 94 (relating to the Revenue Act of 1936) in defining gross income provides in part:

> "Art. 22(c)-1. *Need of inventories.* In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor."

Furthermore, the taxpayer was on an accrual basis (R. 22) and Section 43 of the Revenue Act of 1936 provides:

> "Sec. 43. Period for Which Deductions and Credits Taken.
>
> The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

The specific elimination of Dividends Paid,—one of the two grounds for credit enumerated in Section 14(a)(2) defining "undistributed net income"—clearly indicates the inclusion of the other section—Contracts Restricting Dividends—as one where the accrual is to be permitted. The differentiation between allowing an accrual of amounts used or set aside within the taxable year to pay debts and the disallowance of an accrual for dividends is consistent with the general purpose of the 1936 Act—to raise revenue immediately by forcing corporations to disgorge earnings —since with the relatively slight possibility of capital gains the payment of a debt does not create taxable income for the holder of the obligation, while the payment of a dividend does in most instances result in increased taxes to stockholders.

The case of deductions for bad debts under Section 23(k) of the Revenue Act of 1936 is somewhat analogous to the present case. Under that section "debts ascertained to be worthless and charged off within the taxable year * * *" are deductible from gross income to determine net income. The requirement "within the taxable year" in so far as the physical act of charging off is required may be met in the first months of the succeeding as of the preceding taxable year. *Hamlen v. Welch*, 116 F. (2d) 413 (1940).

In *Kentucky Rock Asphalt Co. v. Helburn*, 20 F. Supp. 364 (Dist. Ct. Ky. 1937) aff'd. 108 F. (2d) 779 (C. C. A. 6, 1940), although the deduction was disallowed on other grounds, the court said at page 368 of 20 F. Supp.:

> "As I have heretofore stated, the administration of the income tax revenue statute is concerned with practical things, and it is hardly feasible for the officers of a corporation to immediately determine at the close of the year deductible bad debts. While the language used in the act provides that the ascertained bad debts shall be 'charged off within the taxable year,' it is not to be presumed that the Congress intended this language to mean all entries on the books of a corporation should be made and the books closed at midnight of the day the taxable year ended. As a practical matter, many facts are assembled as a basis for the book entries after the close of the year, and the Congress did not intend there should be an essential departure from the usual course of business in making book entries in order to comply with the income tax laws."

While thus attempting to eliminate or ignore portions of the statute, the Commissioner is also attempting to insert an additional requirement, i.e., that it is not sufficient that the legal effect of the indenture be to require the setting aside of the earnings, but that there must be expressly in so many words this requirement. Congress did not say this. The attempt of Commissioner to insert "expressly" before the phrase "to be irrevocably set aside within the taxable year" is obviously wrong. Congress was content to provide that only one provision of the contract be "express" and that was the provision which makes it obligatory to use earnings and profits i.e., "• • • which provision *expressly* deals with the disposition of earnings and profits of the taxable year • • •."

For his only specific case authority the petitioner cites *Helvering v. Moloney Electric Co.*, 120 F. (2d) 617 (C. C. A. 8, 1941) (cert. den. Nov. 10, 1941, 314 U. S. 682) (prelim. print) (Rehearing denied Jan. 12, 1942, 315 U. S. 826).

(prelim. print), and *Antietam Hotel Corporation v. Commissioner*, 123 F. (2d) 274 (C. C. A. 4, 1941). While in these cases both Circuit Courts denied claims for credits under Section 26(c)(2) for sinking fund payments, the facts were so different in each case that the opinions would seem to be of only limited value in consideration of the present cases before this Court.

In the *Moloney* case there were claims for two credits. The first was under a provision in a trust indenture that the taxpayer would on the first day of every June as long as there were any bonds outstanding pay "a sum equal to 2% of the largest amount of debenture bonds at any time outstanding, * * *." This requirement was absolute and did not in terms depend on the existence or non-existence of earnings and profits, and therefore was not a provision which, as required by the statute, "expressly deals with the disposition of earnings and profits of the taxable year." Therefore, the court denied this 2% credit.

The claim for a second credit in the *Moloney* case was based on the next phrase in the same sinking fund provision whereby the taxpayer also agreed to "pay on said date [June 1] to the said trustee 20% of the net earnings, for the next preceding year, as hereinafter defined, of the Company in excess of Three Hundred Twenty Thousand Dollars * * *." It was further provided that this 20% should be set aside not later than April 1. Both the Board and the court denied the credit. Reasons for these decisions included (a) the fact that there was no claim on the earnings except those in excess of $320,000; (b) the taxpayer was specifically given until April 1 of the following year to set aside its earnings, and (c) the statement in the opinion of the Board, quoted by the court:

> "* * * There is no evidence upon which to base a conclusion that any portion of the amount paid in 1936 was paid because of petitioner's obligation to apply 20 percent of its net earnings in excess of $320,000 toward the reduction of its indebtedness. The record does not

disclose whether the payment was made near the close of the year when it was apparent that the earnings would be in excess of $320,000 or whether it was made earlier in the year when the earnings were much less than that amount. It seems to be obvious that the payment was made under the option contained in section 3 of article III rather than because of any requirement of the contract that it be made. In any event, in the absence of any showing as to when the payment was made and in the absence of any showing as to the amount of net earnings at that time, it is impossible to find that the payment was made because of the requirement that 20 percent of the net earnings in excess of $320,000 be applied on the debt." 42 B. T. A. at p. 86, as quoted in 120 F. (2d) 617 at 621.

The *Antietam* case (*supra*) does by way of dictum indicate that if it were necessary for decision it would have held that credit could not be granted unless the contract requiring the setting aside of a portion of a year's earnings *expressly* and in its terms required that the setting aside be done within the taxable year. That is the construction sought by the Commissioner here, but, as we believe we have shown, an untenable one. The actual decision in the *Antietam* case was that whether or not required during the taxable year, there had in fact been no payment or setting aside and of course the statute limits the credit "to the extent, that such amount has been so paid or set aside." In other words the only tangible recognition made by the Antietam Hotel corporation was the sinking fund payment in the year following the tax year.

"* * * It is clear from the record, however, that these funds were never actually segregated from the taxpayer's other moneys during the taxable years in question. Indeed, the evidence discloses that during the taxable years in question, the funds actually remained in petitioner's general bank account, and it is quite clear that actual payments to the Trustee were not made during the taxable years, but were, in each instance, paid by check during March of the year

after the taxable year. Thus, there was no definitive act within the taxable year, which divested the corporation's control over the funds." 123 F. (2) at 276-7.

We think that the Circuit Court of Appeals for the Sixth Circuit was right in its treatment of these two cases when it said in its decision in *Commissioner v. Strong Mfg. Co.*:

> "We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp. v. Commissioner of Internal Revenue*, 4 Cir., 123 F. 2d 274, it was held 'that as an indispensable condition precedent to the allowance of the credit, the contract itself must in terms require that a portion of the earnings and profits of the taxable year be * * * irrevocably set aside within the taxable year.' We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, in terms. With regard to the case of *Helvering v. Moloney Electric Co.*, 8 Cir., 120 F. 2d 617, in which it was held that the taxpayer was not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless." 124 F. 2d 360, 365-6.

C. The Congressional intent and the legislative history of the undistributed profits tax imposed by the Revenue Act of 1936 supports the taxpayer's interpretation.

This is a case involving a surtax imposed by Congress on undistributed profits (after they had already been subject to a normal tax) for the avowed purpose of forcing corporate profits into the hands of shareholders where they would be subject to tax. Thus, in the Report on the Revenue Bill of 1936 of the House of Representatives Committee on Ways and Means, after quoting in full the message of the President, the Committee said:

> "The President requests the Congress to raise $620,000,000 of additional revenue annually by some form of permanent taxation. He suggests some form of undistributed-profits tax. Your committee recognizes the fact that the greatest defect in our present system of taxation lies in the fact that surtaxes on individuals are avoided by impounding income in corporate surpluses. Therefore, your committee proposes a plan of taxation which taxes a corporation on the net income, but which fixes the rate in accordance with the proportion of the net income, undistributed.
>
> "The major purposes of the change in the method of taxing corporate incomes are (1) to prevent avoidance of surtax by individuals through the accumulation of income by corporations, (2) to remove serious inequities and inequalities between corporate, partnership, and individual forms of business organization, and (3) to remove the inequity as between large and small shareholders resulting from the present flat corporate rates.
>
> "It is well recognized that the corporate form of doing business enjoys certain advantages over individual and partnership businesses. The existing law creates purely artificial additional advantages in some cases and artificial disadvantages in others, depending upon the size of the enterprise and the character of its ownership. Individuals and partnerships can not minimize their taxes by failure to distribute their business earnings. Corporations should not be permitted to withhold from the beneficial shareholders unneeded

> corporate income at the expense of the revenues of the United States and to the detriment of the shareholder. The bill proposes to remove many of these inequities by relieving from tax corporations which distribute all their net earnings annually as earned, and by taxing corporations accumulating their net income at a rate to compensate to a large extent for the amount of tax on the shareholders' income lost by reason of the failure to make a complete distribution. Adequate safeguards are provided in the bill to prevent unreasonable taxation of incomes in the case of corporations in distress or with inadequate earnings to take care of their immediate business needs. * * *" H. of Rep. Report No. 2475, 74th Congress, Sec. Sess. Cum. Bul. 1939-1 (part 2) 667, 669.

Fairness demanded and Congress provided that credit be given for both dividends paid (Section 27 of the Revenue Act of 1936) since that was the purpose of the surtax and also for "Contracts Restricting Payments of Dividends" as the Congress entitled Section 26(c) of the Revenue Act.

The Commissioner in his brief (pages 19 to 29) states that there were two proposed forms[1] of the tax on undistributed profits—one the House bill and the other the Senate bill—before the adoption of the bill in its final form. He shows that under each of the proposed forms and the "cushions" in each there would have been little or no relief for a taxpayer under the circumstances present in this case and therefore, so the argument goes, the Court should not find in the existing "cushions" any relief for the taxpayers. This conclusion is false, it can be shown, both generally and specifically. *Generally* in that if the Congress as a whole is unable to agree on forms noteworthy for their harshness, then it would be supposed that the sub-

[1] As a matter of fact there were at least four major forms of the bill, which embodied two distinct theories of the tax, before the fifth and final conference form was adopted. For the purpose of presenting a full picture there is included in the appendix a detailed explanation of the changes, as shown by the Commerce Clearing House Special Reports on the Revenue Bill of 1936.

stituted bill had relief provisions of a more adequate nature. This was done, for as Senator Connally said to the Senate in explaining the sections which finally became the law:

> "• • • One of the reasons that made some of us timid about embracing the new principle was that the Government and the Treasury had no experience, had the benefit of no accumulated studies as to a tax on undistributed profits. So instead of discarding all present taxes and embarking upon an absolutely untried and new plan, we proposed that we should retain in large measure the present normal rates and cautiously extend our footsteps into the new and untried territory. That is what we have done." (Cong. Rec., Vol. 80, p. 10,474.)

Specifically the facts that show the falsity of the Commissioner's argument appear upon careful examination of each of the proposed bills and comparison of them with the enacted bill. In the House bill there was, as stated by the Commissioner, a proposal to entirely eliminate the "normal" tax and substitute a tax of from zero to 42½ per cent on the undistributed net income (Appendix A, p. 38). There was partial relief given by specific provisions regarding deficit corporations or corporations heavily in debt (See Sections 14 and 16 of Appendix A). And it may be admitted, as stated by the Commissioner, that the taxpayer in this case would have had only partial relief from these specific cushions. What Commissioner overlooks is the fact that total effect was to be greatly diminished by the omission of the normal tax. Congressman Vinson stated that under the House bill there would be a "cushion" in that small corporations (i.e., ones with income up to $10,000) would retain up to 42% of their net income and the larger corporations up to 31.9% without paying any more tax than under the then existing law and rates of the 1934 Act (Cong. Record, Vol. 80, pp. 6212-13).

The "cushion" in the Senate Committee bill (Appendix C, p. 51) was the moderateness of the straight rate

of 7% on undistributed profits in addition to the "normal tax" which the Senate restored. This moderate rate permitted the Senate in its proposed bill "to eliminate the complicated relief provisions of the House bill relating to debt and deficit of corporations." (Senator King, Cong. Record, Vol. 80, p. 8649.)

The "cushion" in the form of the low surtax rate was not enough to satisfy the Senate, which added by a floor amendment Section 26(c)(2) in the form in which it was finally adopted. See Appendix D, p. 56.

The final bill contained neither of the original "cushions"—that is it has the regular "normal" tax, Sec. 13[1] with rates from 8% to 15%[1] plus the "Surtax on Undistributed Profits" with rates from 7% to 27%. This situation made it more imperative than ever that the relief given by the Senate floor amendment to corporations which, by contract, inevitably had to draw upon current earnings to pay prior indebtedness, should be retained.

Likewise misleading and irrelevant is Commissioner's argument on the "dividend year" point (Pet. Br. 25-28). Congress first provided for a "dividend year" to enable a corporation to have some time after the close of the taxable year to cast up its accounts, determine how much

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[1] SEC. 13. NORMAL TAX ON CORPORATIONS.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:

Upon normal-tax net incomes not in excess of $2,000, 8 per centum.

$160 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 11 per centum in addition of such excess.

$1,590 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 13 per centum in addition of such excess.

$4,840 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 15 per centum in addition to such excess.

it wanted to distribute in the way of dividends. Later this was eliminated and in response to questions Mr. Hill, Chairman of the Subcommittee of the House Ways and Means Committee, said, as quoted on page 28 of Commissioner's Brief, that corporations for the purpose of distribution of dividends would know before the end of the year "approximately what their earnings are." Therefore, petitioner's argument goes, Congress was aware of the difficulties which would prevent a corporation from making an exact determination of its sinking fund payment within the taxable year and therefore did not intend, that the taxpayers whose debt payments were to be measured by the net income of an entire year.

This argument of the petitioner ignores three fundamental points:

1. The difference between the determination of the amount *desirable* to pay out as dividends and the amount *required* to be paid to a sinking fund. In the case of dividends a corporation's board of directors upon a close approximation of its net earnings fixes a lump sum that will usually give an "even" amount per share—as $1.50, $4.00—$5.25. That is, there is no need to distribute right down to the last dollar of earnings or of a fixed percentage of earnings. On the other hand the sinking fund requirements are for *exact* amounts—viz., for this taxpayer $11,017.22 in 1936 and $13,053.52 in 1937. That is why Congress provided credits for money which had to be "irrevocably set aside within the taxable year for the discharge of a debt."

2. A primary aim of the undistributed profits tax was that "unduly accumulated earnings and profits • • • go through the tax mill in the hands of the shareholder" (Congressman Buck at Cong. Record, Vol. 80, p. 6228). And also it was part of this aim that the shareholders would not be able to defer distributions until such times as it suited—for example, in a year in which they would have

losses to offset the income. On the other hand the payment of debts rarely creates taxable income in the hands of the creditor. Thus Congress permitted a credit for moneys which were merely irrevocably set aside for the payment of debts, while it required an actual payment of dividends for the dividend credit under Section 27.

3. Congress did put in Section 26(c)(2) after having heard the protests and with the intention of taking care of situations including obligations of the corporation to pay debts or withhold earnings for specific purposes under contract. (This, as the petitioner candidly points out in a footnote (Pet. Br. p. 23) but ignores in argument, was the explanation given by Senator Couzens at Cong. Record, Vol. 80, p. 9071 for the present form of 26(c)(2).)

In the course of his discussion of legislative proceedings the Commissioner also argues that the legislative history of the 1938 Act shows that the credit provisions of the 1936 Act were intended by Congress to be carefully limited. Granted that the legislative history of the 1938 Act shows an intent to make (which intent was carried out) the credit provisions of that Act broader than those of the 1936 Act, there is nothing in the legislative history of the 1938 Act, to show that the 1936 credit provisions were intended to be so limited as to deny the credit to this taxpayer. The Commissioner's argument might have some merit, if the taxpayer were relying upon the provisions of the 1938 Act as being declaratory of the Congressional intent in enacting the 1936 credit provisions, but the fact that Congress subsequently enlarged the credit provisions cannot serve as a basis for denying the credit to one who comes within the terms of the statute. Cf. *Penn Mutual Life Ins. Co. v. Lederer*, 252 U. S. 523, 537.

D. All of the rules of statutory construction applicable support the allowance of the credit in this case.

Other than the rule first cited in the preceding argument—that every word and phrase of a statute must be considered, *Ex Parte Public Bank*, 278 U. S. 101—we do not believe that rules of statutory construction are necessary or proper in the determination of this case, for as the Court said in *Western & Southern Life Ins. Co. v. Huwe*, 116 F. (2d) 1008, at 1010 (C. C. A. 6, 1941):

> "A taxing statute must be taken as it stands and where the language is plain and unambiguous as here, there is no ground for addition or subtraction."

If, however, there is doubt concerning the applicability of this statute then since the construction urged by the Commissioner makes part of the statute meaningless or absurd, the taxpayer is entitled to "that construction most favorable to him." *Partee v. Commissioner*, 114 F. (2d) 716, 719 (C. C. A. 6, 1940), Cf. *White v. Aronson*, 302 U. S. 16 at 21, for "taxation being an intensely practical matter, the courts, in construing laws in respect thereto should avoid, so far as possible, unjust and oppressive consequences." *Buhl v. Kavanagh*, 118 Fed. (2d) 315, 323 (C. C. A. 6, 1941), "While the title of an act will not limit the plain meaning of the text [citing cases] it may be of aid in resolving an ambiguity." *Maguire v. Commissioner*, 313 U. S. 1, 9 (1941); *United States v. Katz*, 271 U. S. 354, 357 (1926). The title of section 14 of the Revenue Act of 1936 imposing the tax here involved is "Surtax on Undistributed Profits" and the title of subsection 2 of section 26(c) "Contracts Restricting Payments of Dividends" is "(2) Disposition of Profits of Taxable Year," and as the Supreme Court said in the *Northwest Steel Mills* case, *supra*, "It is true that the surtax is imposed upon the annual net income *only if it is not distributed*, * * *" (italics ours) and "the intention of the Congress must be gathered from the language of the Act

because a tax statute must be construed to take from the taxpayer no more than it plainly intends." *United States v. Stroop*, 109 F. (2d) 891, 893 (C. C. A. 6, 1940).

In a case wherein the court held against the imposition of a federal estates tax, *Lynch, Collector, v. Union Trust Co.*, 164 Fed. 161 (C. C. A. 9th, 1908; cert. den. 214 U. S. 523), the court said (p. 163):

> "• • • Primarily in this connection it is necessary to keep in view a cardinal principle, to be applied generally to the interpretation of legislation whereby the government seeks to impose a duty or burden upon the property or rights of the citizen in the nature of taxation, and more especially applicable to *statutes such as this, seeking to impose a burden of a special or unusual character, and that is that, in all cases of doubt or ambiguity arising on the terms of such a statute, every intendment is to be indulged against the taxing power.*" (Italics added.)

The following Supreme Court cases have firmly established the rule that in determining the incidence of a tax doubts are resolved in favor of the taxpayer:

Hassett v. Welch, 303 U. S. 303, 314 (1938);
White v. Aronson, 302 U. S. 16, 20 (1937);
Gould v. Gould, 245 U. S. 151, 153 (1917).

The Commissioner makes the contention that the taxpayer is claiming an exemption and therefore must bring itself strictly within the terms of the statute and that any doubt is to be resolved in favor of the Government. If this be considered to be an exemption case, then the statement of Mr. Justice Cardozo in *Trotter v. Tennessee*, 290 U. S. 354 (1933), is most relevant. He said (p. 356):

> "Exemptions from taxation are not to be enlarged by implication if doubts are nicely balanced. *Chicago Theological Seminary v. Illinois*, 188 U. S. 662, 674. On the other hand, *they are not to be read so grudgingly as to thwart the purpose of the lawmakers.*" (Italics added.)

However, the question presented here is not an exemption in the true sense. The intendment of Congress was to lay a surtax on *undistributed* profits. *Helvering v. Northwest Steel Mills, supra*, and while in that case the court held that the taxpayer's claim under Section 26(c)(1) was for a credit in the matter of a specially permitted deduction and therefore to be strictly construed, it is significant that the sums there under consideration had not been distributed.

The sums under consideration here have been subject to the normal income tax and have been distributed. The broad issue is whether they are now subject to a further tax as "undistributed" in spite of the fact that they have been distributed pursuant to provisions of the trust indenture which "inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments." *G. B. R. Oil Corporation, infra, Chesapeake Ferry Company, infra.*

In *G. B. R. Oil Corporation v. Commissioner*, 40 B. T. A. 738 (1939) the taxpayer, a corporation organized to develop and operate oil leases, borrowed money from a bank to use in the purchase of interests in oil leases. The bank was secured by deed of trust liens on the properties and also by assignments of the taxpayer's interests in the properties in trust, which assignments authorized the bank to receive and collect all sums of money derived from the properties and to apply the same on the indebtedness to the bank.

As a practical matter, because it was understood that the properties had to be operated and expenses paid, the bank credited the payments it received from the taxpayer's oil customers to the taxpayer's account, with an understanding that out of the funds deposited nothing would be paid of any character whatever except the actual, necessary and usual operating expenses, and the balance would be applied to the reduction of the loans. The taxpayer was also permitted to expend from the moneys thus deposited

considerable sums (about twenty-five thousand dollars) in development to increase production. The taxpayer's claim for a credit under Section 26(c)(2) of the Revenue Act of 1936 for all of the amounts paid to the bank in 1936 under this arrangement was allowed by the Board, which said in part at page 743 of 40 B. T. A.:

> "In determining whether the claimed credit of a corporate taxpayer falls within section 26(c)(2) and the regulations promulgated thereunder, three things seem to be necessary:
>
> "(1) There must be a written contract executed prior to May 1, 1936, which expressly deals with the disposition of earnings and profits of the taxable year.
>
> "(2) The credit relates to that portion of the earnings or profits which are required to be paid or irrevocably set aside in the discharge of a debt.
>
> "(3) The credit is allowable to the extent that the money has been so paid or set aside."

After determining that the taxpayer in the *G. B. R. Oil Corporation* case had met these conditions the Board, in holding that the credit should be granted, said at page 744 of 40 B. T. A.:

> "The general purpose of section 26(c)(2), it seems to us, is to give a credit where a dividend paid credit can not be secured. In other words, the basic intent of Congress seems to have been to include in the provision only contracts which inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments. See *Paul and Mertens*, par. 32 A. 46, 1938 cumulative supplement.
>
> "Respondent in his brief cites no authority in support of his contention, but, after quoting the language of the assignments from petitioner to the bank, says:
>
> " 'We are unable to find in these contracts or assignments any provision which expressly deals with the disposition of petitioner's earnings and profits of the taxable year.'

"It is true, as we have already said, that the assignments in question do not expressly refer to 'earnings and profits' as such, but they certainly do require that all of petitioner's gross receipts from these properties be paid to the bank and that would certainly include all 'earnings and profits' from them.

"Respondent says in his brief that petitioner 'could have declared a dividend out of its earnings and profits of the taxable year and paid same with borrowed money, notes, credits, or in stock.' Perhaps it could have done so. We do not consider that is a matter which we have to decide. Even assuming that it is so, we do not see where that fact affects the application of the credit provided by section 26(c)(2). We sustain petitioner in this assignment of error.

"Reviewed by the Board."

In *Chesapeake Ferry Company v. Early, Jr., Collector*, ... F. Supp. ..., 39—2 U. S. T. C. § 9786, p. 10,923 (Dist. Ct. Va., 1939) the court at first denied a credit claimed under Section 26(c)(2) of the Revenue Act of 1936 for sinking fund payments made under a deed of trust. However, after the *G. B. R. Oil Corporation* case, *supra*, had been decided, the court filed an "Additional Memorandum" saying in part (p. 10,924):

"Upon re-hearing and re-consideration and in the light of the Board's decision, [in the *G. B. R. Oil* case] above quoted, I am of the opinion that the provisions of the deed of trust in question 'inevitably require in their performance a drawing on current earnings, thus removing current earnings as a source of dividend payments,' and that petitioner is entitled to the relief sought."

The sums paid by Warren Tool Corporation for the purchase of the bonds toward the close of each taxable year after the earnings for each year had been estimated are sums which, to the extent they represented twenty-five per cent of the net earnings of the taxpayer as finally determined, were irrevocably set aside pursuant to the provision

of a contract, the performance of which inevitably required a drawing on current earnings thus removing current earnings as a source of dividend payments.

CONCLUSION.

It is respectfully submitted that the decision of the Sixth Circuit Court of Appeals that there is no deficiency in the Surtax on Undistributed Profits for the taxable years 1936 and 1937 should be sustained.

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October 13, 1942.

APPENDIX A.

H. R. 12395 74th Congress 2nd Session.
As introduced in the House April 21, 1936.

SEC. 13. TAX ON CORPORATIONS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income in excess of the credit provided in section 26 (relating to interest on certain obligations of the United States and Government corporations);

(2) The term "undistributed net income" means the adjusted net income minus the sum of—

(A) The dividend credit provided in section 27; and

(B) The tax computed under subsection (b).

(b) *Rate of Tax in General.*—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation a tax as follows:

(1) *Adjusted Net Income $10,000 or Less.*—If the adjusted net income is not more than $10,000 the tax shall be computed under Schedule I or, at the option of the corporation, under Schedule IA (the tax being the same under both Schedules).

(2) *Adjusted Net Income More Than $10,000.*—If the adjusted net income is more than $10,000 the tax shall be computed under Schedule II or, at the option of the corporation, under Schedule IIA (the tax being the same under both Schedules); except that if the adjusted net income is less than $40,000 and if the tax would be less if computed under Schedule III, then the tax shall be computed under Schedule III.

SCHEDULE I—ADJUSTED NET INCOME OF $10,000 OR LESS BASED ON UNDISTRIBUTED NET INCOME

If the undistributed net income equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	Column 2	Column 1	Column 2	Column 1	Column 2
0	....	24	5.10	48	17.40
1	0.10	25	5.50	49	17.95
2	0.20	26	5.90	50	18.50
3	0.30	27	6.30	51	19.05
4	0.40	28	6.70	52	19.60
5	0.50	29	7.10	53	20.15
6	0.60	30	7.50	54	20.70
7	0.70	31	8.05	55	21.25
8	0.80	32	8.60	56	21.80
9	0.90	33	9.15	57	22.35
10	1.00	34	9.70	58	22.90
11	1.25	35	10.25	59	23.45
12	1.50	36	10.80	60	24.00
13	1.75	37	11.35	61	24.55
14	2.00	38	11.90	62	25.10
15	2.25	39	12.45	63	25.65
16	2.50	40	13.00	64	26.20
17	2.75	41	13.55	65	26.75
18	3.00	42	14.10	66	27.30
19	3.25	43	14.65	67	27.85
20	3.50	44	15.20	68	28.40
21	3.90	45	15.75	69	28.95
22	4.30	46	16.30	70	29.50
23	4.70	47	16.85		

If the undistributed net income is a percentage of the adjusted net income which is less than 10 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to one-tenth of the percentage which the undistributed net income is of the adjusted net income.

If the undistributed net income is a percentage of the adjusted net income which is more than 10 and less than 20 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to the sum of 1, plus one-fourth of the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 10.

If the undistributed net income is a percentage of the adjusted net income which is more than 20 and less than 30 (and such percentage is not shown in the foregoing

table) the tax shall be a percentage of the adjusted net income equal to the sum of 3.5, plus four-tenths of the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 20.

If the undistributed net income is a percentage of the adjusted net income which is more than 30 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to the sum of 7.5, plus fifty-five one-hundredths of the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 30.

SCHEDULE IA—ADJUSTED NET INCOME OF $10,000 OR LESS BASED ON DIVIDEND CREDIT

If the dividend credit equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	*Column 2*	*Column 1*	*Column 2*	*Column 1*	*Column 2*
0	29.6774	40	15.4839	80	2.8000
..	.....	..	.....	..	.....
10	26.1290	50	11.9355	90	0.9091
..	.....	..	.....	..	.....
20	22.5806	60	8.3871	100	.....
..	.....	..	.....		
30	19.0323	70	5.3571		
..	.....	..	.....		

[NOTE: This schedule has been shortened by the indicated omissions and four paragraphs of text immediately following the schedule which paragraphs are "interpolators" similar in operation to those under Schedule I have also been omitted. The same omissions have been made under Schedules II and IIA.]

SCHEDULE II—ADJUSTED NET INCOME OF MORE THAN $10,000 BASED ON UNDISTRIBUTED NET INCOME

If the undistributed net income equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	Column 2	Column 1	Column 2	Column 1	Column 2
0	..	20	9.0	50	35.0
..	..	..	..	..	..
1	.4	30	15.0	57.5	42.5
..	..	..	..	..	..
10	4.0	40	25.0		
..	..	..	..		

[NOTE: See note under Schedule IA explaining omission of figures and "interpolators".]

If the undistributed net income is a percentage of the adjusted net income which is more than 30 (and such percentage is not shown in the foregoing table) the tax shall be a percentage of the adjusted net income equal to the sum of 15, plus the amount by which the percentage which the undistributed net income is of the adjusted net income exceeds 30.

Schedule IIA—Adjusted Net Income of More Than $10,000 Based on Dividend Credit.

If the dividend credit equals a percentage of the adjusted net income shown in column 1 of the following table, then the tax shall be the percentage of the adjusted net income shown opposite in column 2.

Column 1	Column 2	Column 1	Column 2	Column 1	Column 2
0	42.5	40	22.500	80	6.00000000
..	..	..	..	..	..
1	42.0	50	17.500	90	2.85714286
..	..	..	..	..	..
10	37.5	60	13.125	100	..
..	..	..	..		
20	32.5	70	9.3750		
..	..	..	..		
30	27.5	79	6.33333333		
..	..				

[NOTE: See note under Schedule IA explaining omission of figures and "interpolators".]

SCHEDULE III—ALTERNATIVE SCHEDULE FOR ADJUSTED NET INCOME OF MORE THAN $10,000 AND LESS THAN $40,000

If the adjusted net income is more than $10,000 and less than $40,000 the tax shall be computed by adding:

(A) A tax computed under Schedule I. For such purpose the percentage which the undistributed net income is of the adjusted net income shall be ascertained by subtracting from the adjusted net income the dividend credit and a tax determined under Schedule II or IIA; and

(B) A tax upon the amount of the adjusted net income in excess of $10,000 at the rate which would be applied if the tax upon the entire adjusted net income were being computed under Schedule II. For such purpose the percentage which the undistributed net income is of the adjusted net income shall be ascertained by subtracting from the adjusted net income the dividend credit and a tax determined under Schedule II or IIA.

(c) *Exempt Corporations.*—For corporations exempt from tax, see section 101.

(d) *Banks and Trust Companies.*—For taxation of certain banks and trust companies, see section 104.

(e) *Receiverships.*—For taxation of domestic corporations in receivership, see section 105.

(f) *Improper Accumulation of Surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

(a) *General Rule.*—If the accumulated earnings and profits of the corporation as of the close of the taxable year (computed without diminution by reason of the distribution during the taxable year of earnings and profits, or by reason of the taxes imposed by this title for the taxable year) are less than the adjusted net income, the tax imposed by section 13 shall, in lieu of being computed under section 13, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) *Tax Not To Be Increased.*—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

SEC. 15. CONTRACTS NOT TO PAY DIVIDENDS.

(a) *General Rule.*—If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the dividend year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22% per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the dividend year from being paid as dividends during the dividend year; and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(b) *Tax not to be Increased.*—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

SEC. 16. DEBTS.

(a) *Definition of "Debt."*—As used in this section the term "debt" means an indebtedness of the corporation existing at the close of business on March 3, 1936, and evi-

denced by a bond, note, debenture, certificate of indebtedness, mortgage, or deed of trust, issued by the corporation and in existence of the close of business on March 3, 1936, or by a bill of exchange accepted by the corporation prior to, and in existence at, the close of business on such date; to the following extent:

(1) If having a maturity at the time of issue of three years or more, then to the full amount thereof;

(2) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to represent indebtedness incurred by the corporation prior to March 4, 1933; or

(3) If having a maturity at the time of issue of less than three years, then to the extent shown to the satisfaction of the Commissioner (whose decision shall be final) to evidence indebtedness of the corporation incurred in the acquisition of capital assets, except (A) shares of stock in any corporation, or (B) rights to subscribe for or to receive such shares, or (C) bonds, debentures, notes, or certificates or other evidences of indebtedness, issued by any corporation, with interest coupons or in registered form, or (D) certificates of profit, or of interest in property or accumulations, in any investment trust or similar organization holding or dealing in any of the instruments mentioned or described in this paragraph, regardless of whether or not such investment trust or similar organization constitutes a corporation within the meaning of this Act.

(b) *Computation of Tax.*—If the sum of all the debts computed under subsection (a) of this section is in excess of the accumulated earnings and profits of the corporation as of the day before the first day of its first taxable year beginning after December 31, 1935, and if the corporation, in its return for its first taxable year under this title, specifies the number of consecutive taxable years (not less than five) over which such debt excess shall be amortized for the purposes of this subsection, then for such number of consecutive taxable years, beginning with the first taxable year of the corporation under this title (or if no such specification is made, then for the first ten taxable years)

the tax imposed by section 13, in lieu of being computed under such section, shall be computed by adding:

(1) A tax of 22½ per centum of an amount of the adjusted net income equal to the amount of such debt excess divided by the number of years so specified (or, if no specification, then by ten); and

(2) A tax upon the remainder of the adjusted net income (less the tax under paragraph (1)) computed under section 13 as if the adjusted net income were equal to the amount of such remainder so reduced.

(c) *Tax Not to be Increased.*—This section shall not be applied in any case in which such application would operate to increase the tax which would be payable without its application.

(d) *List of Evidences of Indebtedness.*—Every corporation shall accompany its return for its first taxable year under this title with an itemized list (prepared in accordance with regulations prescribed by the Commissioner, with the approval of the Secretary) of the bonds, notes, and other instruments which it claims evidence indebtedness coming within the meaning of the term "debt" as defined in subsection (a). For the purposes of this section no debt shall be included in computing debts under section (a) unless the instrument evidencing such debt is included in such list.

SEC. 17. APPLICATION OF SECTIONS 14, 15, AND 16 TO SAME TAXABLE YEAR.

If in the case of any corporation more than one of sections 14, 15, and 16 are applicable, the tax shall be computed under the one of such sections which will produce the least tax.

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Definition of "Dividend Year."*—The term "dividend year," when used in this title with reference to a corporation, means the period beginning on the fifteenth day of the third month after the day before the beginning of the taxable year (whether the taxable year is a period of

twelve months or a shorter period) and ending on the fourteenth day of the third month after the close of the taxable year.

(b) *Dividend Credit in General.*—For the purposes of this title, the dividend credit shall be the amount of dividends paid during the dividend year corresponding to the taxable year.

(c) *Dividend Carry-Over.*—In computing the dividend credit for any taxable year, if the dividends paid during the dividend year are less than the adjusted net income, there shall be allowed as part of the dividend credit, and in the following order:

(1) Dividends paid during the second preceding dividend year in excess of the adjusted net income for the corresponding taxable year, to the extent not needed as a dividend credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding dividend year in excess of the adjusted net income for the corresponding taxable year.

In the case of a taxable year the tax for which has been or is being computed under section 14 or 15 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (a) (2) of such section; and in case of a taxable year the tax for which has been or is being computed under section 16 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (b) (2) of such section. No credit shall be allowed for dividends paid by a corporation prior to the 15th day of the third month of its first taxable year under this title.

(d) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividend credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(e) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividend credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the dividend year in which the redemption occurs.

(f) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividend credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

(g) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividend credit under this section, be treated as a taxable dividend paid.

(h) *Preferential Dividends.*—No dividend credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class, and each of the shareholders of that class, who are subject to taxation under this title for the period in which the distribution is made, receives a taxable dividend as a result of the distribution.

(i) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividend credit shall be allowed with respect to such part.

(j) *Intercorporate Dividends.*—If 80 per centum or more of the gross income of the corporation is derived from dividends, then the dividend credit with respect to

each dividend payment shall be reduced to an amount equal to the sum of:

(1) The portion of such dividend payment paid to shareholders other than corporations;

(2) The portion of such dividend payment paid to corporations taxable under section 104, 105, 201, 204, 207, 231, 251, or 261, or to corporations exempt from taxation under section 101;

(3) The portion of such dividend payment made to a corporate shareholder owning less than 50 per centum of the class of stock with respect to which the dividend is paid; and

(4) An amount of such dividend payment paid to other corporate shareholders which bears the same ratio to the total dividend payment paid to them as the part of the gross income not derived from dividends bears to the entire gross income.

APPENDIX B.

House Amendments to H. R. 12395 as Passed by the House April 29, 1936.

SEC. 14. ACCUMULATED EARNINGS AND PROFITS LESS THAN ADJUSTED NET INCOME.

Sec. 14 (a) (1) relating to special tax where corporation has a deficit, is amended by changing the rate from 22½ per cent to 15 per cent so that it reads as follows:

(1) A tax of 15 per centum of the excess of the adjusted net income over such accumulated earnings and profits; and

SEC. 15. CONTRACTS NOT TO PAY DIVIDENDS.

Subsection (a) and subdivision (1) thereof of Sec. 15 are amended by changing "dividend year" to "taxable year" so that the subsection reads as follows:

(a) *General Rule.*—If under a written contract executed by the corporation prior to March 3, 1936, there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends, the tax imposed by section 13 shall, in lieu of being computed under such section, be computed by adding:

(1) A tax of 22½ per centum of the excess of the adjusted net income over the amount which is not prohibited during the whole of the taxable year from being paid as dividends during the taxable year; and

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividend Credit in General.*—For the purposes of this title, the dividend credit shall be the amount of dividends paid during the taxable year.

(b) *Dividend Carry-Over.*—In computing the dividend credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividend credit, and in the following order:

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividend credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

In the case of a taxable year the tax for which has been or is being computed under section 14 or 15 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (a) (2) of such section; and in case of a taxable year the tax for which has been or is being computed under section 16 the term "adjusted net income" as used in this subsection means the amount subject to tax under subsection (b) (2) of such section. No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividend credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividend credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corporation, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

[No amendments (except the relettering) were made to the newly relettered subsections (e) to (i).]

APPENDIX C.

H. R. 12395 as Reported to the Senate June 1, 1936.

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) *Definition.*—As used in this title the term "normal-tax net income" means the net income minus the sum of—

(1) *Interest on obligations of the United States and its instrumentalities.*—The credit provided in section 26 (a).

(2) *Dividends received.*—The credit provided in section 26 (b).

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every corporation, a normal tax as follows:

Upon normal-tax net incomes not in excess of $2,000, 15½ per centum.

$310 upon normal-tax net incomes of $2,000; and upon normal-tax net incomes in excess of $2,000 and not in excess of $15,000, 16 per centum in addition of such excess.

$2,390 upon normal-tax net incomes of $15,000; and upon normal-tax net incomes in excess of $15,000 and not in excess of $40,000, 17 per centum in addition of such excess.

$6,640 upon normal-tax net incomes of $40,000; and upon normal-tax net incomes in excess of $40,000, 18 per centum in addition of such excess.

(c) *Exempt Corporations.*—For corporations exempt from taxation under this title, see section 101.

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts not to pay dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax of 7 per centum of the amount of the undistributed net income.

(c) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks. As used in this paragraph the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions.

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are subject to the tax imposed under section 251.

(6) Corporations organized under the China Trade Act, 1922.

(d) *Exempt Corporations.*—For corporations exempt from taxation under this title, see section 101.

(e) *Tax on Personal Holding Companies.*—For surtax on personal holding companies, see section 351.

(f) *Improper Accumulation of Surplus.*—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

(a) *Interest on Obligations of the United States and Its Instrumentalities.*—The amount received as interest upon obligations of the United States or of corporations organized under Act of Congress which is allowed to an individual as a credit for purposes of normal tax by section 25 (a) (1) or (2).

(b) *Dividends Received.*—90 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

(c) *Contracts Not to Pay Dividends.*—The amount by which the adjusted net income exceeds the amount which during the whole of the taxable year is not prohibited by a contract from being paid as dividends during the taxable year. As used in this subsection, the term "contract" means a written contract executed by the corporation prior to March 3, 1936, under which there is no form in which dividends equal to the adjusted net income for the taxable year may be paid during the taxable year without violating a provision of such contract expressly dealing with the payment of dividends.

(d) *Bank Affiliates.*—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount of the earnings or profits which the Board of Governors of the Federal Reserve System certifies to the

Commissioner has been devoted by such affiliate during the taxable year to the acquisition of readily marketable assets other than bank stock in compliance with section 5144 of the Revised Statutes, but the aggregate amount allowable under this subsection for all taxable years shall not exceed the amount required to be devoted under such section to such purposes.

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) *Dividends Paid Credit in General.*—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

(b) *Dividend Carry-Over.*—In computing the dividends paid credit for any taxable year, if the dividends paid during the taxable year are less than the adjusted net income, there shall be allowed as part of the dividends paid credit, and in the following order:

(1) Dividends paid during the second preceding taxable year in excess of the adjusted net income for such year, to the extent not needed as a dividends paid credit for the taxable year preceding the taxable year the tax for which is being computed; and

(2) Dividends paid during the first preceding taxable year in excess of the adjusted net income for such year.

No credit shall be allowed for dividends paid by a corporation prior to its first taxable year under this title.

(c) *Dividends in Kind.*—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

(d) *Dividends in Obligations of the Corporation.*—If a dividend is paid in obligations of the corporation, the amount of the dividends paid credit with respect thereto shall be the face value of the obligations, or their fair market value at the time of the payment, whichever is the lower. If the fair market value is lower than the face value, then when the obligation is redeemed by the corpora-

tion, the excess of the amount for which redeemed over the fair market value at the time of the dividend payment (to the extent not allowable as a deduction in computing net income for any taxable year) shall be treated as a dividend paid in the taxable year in which the redemption occurs.

(e) *Taxable Stock Dividends.*—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

(f) *Distributions in Liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the dividends paid credit under this section, be treated as a taxable dividend paid.

(g) *Preferential Dividends.*—No dividends paid credit shall be allowed with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock as compared with other shares of the same class.

(h) *Nontaxable Distributions.*—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

APPENDIX D.

Senate Amendments to H. R. 12395 as passed by the Senate June 5, 1936.

SEC. 13. NORMAL TAX ON CORPORATIONS.

(a) *Definition.*—As used in this title the term "normal-tax net income" means the net income minus the sum of—

(1) Interest on obligations of the United States and its instrumentalities.—The credit provided in section 26 (a).

(2) Dividends received.—The credit provided in section 26 (b).

(3) Dividends paid.—In the case of mutual investment companies the credit provided in section 27.

[(b)-(c). Unchanged from Senate Committee Bill.]

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

[(a)-(b). Unchanged from Senate Committee Bill.]

(c) *Exemption From Surtax.*—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks. As used in this paragraph the term "bank" means a bank, or a banking institution engaged only in a business similar to that transacted by Morris Plan banks, or a trust company, incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia), of any State, or of any Territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under section 11 (k) of the Federal Reserve Act, as amended, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions.

[(2)-(6). Unchanged from Senate Committee Bill.]

[(d)-(i). Unchanged from Senate Committee Bill.]

[Secs. 21-25. Unchanged from Senate Committee Bill.]

SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

[(a). Unchanged from Senate Committee Bill.]

(b) *Dividends Received.*—90 per centum of the amount received as dividends from a domestic corporation which is subject to taxation under this title. The credit allowed by this subsection shall not be allowed in respect of dividends received from a corporation organized under the China Trade Act, 1922, or from a corporation which under section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States. The credit allowed by this subsection shall not be allowed to mutual investment companies. (For definition of mutual investment company, see section 1001.)

(c) *Contracts Restricting Payment of Dividends.*—

(1) Prohibition on payment of dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) Disposition of profits of taxable year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such

amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) Double credit not allowed.—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

[(d). Unchanged from Senate Committee Bill.]

SUPREME COURT OF THE UNITED STATES.

Nos. 40, 41, and 42.—October Term, 1942.

Helvering, Commissioner of Internal Revenue, Petitioner,
40 *vs.*
The Ohio Leather Company.

Helvering, Commissioner of Internal Revenue, Petitioner,
41 *vs.*
The Strong Manufacturing Company.

Helvering, Commissioner of Internal Revenue, Petitioner,
42 *vs.*
Warren Tool Corporation.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[November 9, 1942.]

Mr. Justice Murphy delivered the opinion of the Court.

The issue is whether respondents are entitled to certain claimed credits against their undistributed profits tax for the 1936 taxable year[1] by virtue of § 26(c)(2) of the Revenue Act of 1936, 49 Stat. 1648.[2]

In each of these cases the taxpayer corporation contracted prior to May 1, 1936, by a written agreement to apply a per-

[1] Taxpayer in No. 42 is also claiming a credit for the 1937 taxable year.

[2] Sec. 26. Credits of Corporations.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

. . . . . .

(c) *Contracts Restricting Payment of Dividends.*—

. . . . . .

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt, to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside

centage of its net earnings of a particular calendar year to an indebtedness of the corporation; in each case the agreement expressly provided only that the payment of the specified percentage was to be made on or before a certain date—April 1 in the case of The Ohio Leather Company and Warren Tool Corporation and April 15 in the case of The Strong Manufacturing Company—in the year following the calendar year during which the net earnings arose.[3] However, the specified percentage was actually paid during the taxable year in each case. By reason

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an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

[3] The relevant contractual provisions in each case are as follows:

No. 40.

By an indenture entered into on April 17, 1936, The Ohio Leather Company covenanted to pay $25,000 annually to a trustee to create a sinking fund for the security of its debentures, and further covenanted that it would "on or before the next succeeding first day of April, pay an amount equal to ten per cent (10%) of the net earnings earned by the Company during the fiscal year ending on the thirty-first day of the next preceding December, as such net earnings are defined hereinafter in the Article, which sums and amounts shall by held by the Trustee for the security of all outstanding Debentures until paid out as hereinafter provided."

No. 41.

By a note and mortgage agreement executed April 15, 1932, The Strong Manufacturing Company bound itself to apply forty per centum of its net earnings upon its unpaid obligation. The mortgage provided:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note.

. . . . . .

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

No. 42.

On November 1, 1932, the Warren Tool Corporation executed a first mortgage and deed of trust to secure a bond issue. The mortgage contained a sinking fund provision which required the Corporation on and after April 1, 1935, to pay to the trustee "on or before the 1st day of April of each year thereafter to and including April 1, 1942, a sum of money equal to Twenty-five Per Cent (25%) of its net earnings for the calendar year next preceding."

of these contracts and payments, taxpayers have sought to avail themselves of the credit authorized by § 26(c)(2), which relieves from the tax on undistributed profits, imposed by § 14 of the 1936 Act, any profits which may not be distributed because of a contract requiring that a portion of earnings of the taxable year be paid or irrevocably set aside within the taxable year for the discharge of a debt. The Commissioner of Internal Revenue determined that the credits claimed should not be allowed, and assessed deficiencies in each case. The Board of Tax Appeals overruled the Commissioner, and the Circuit Court of Appeals affirmed.[4] We granted certiorari because of an asserted conflict with *Antietam Hotel Corp.* v. *Commissioner*, 123 F. 2d 274.[5]

Since § 26(c)(2) grants a special credit in the nature of a deduction, the taxpayer must sustain the burden of showing compliance with its exact terms. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49; *White* v. *United States*, 305 U. S. 281, 292; *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440. We agree with the Commissioner that taxpayers have not carried that burden.

Section 26(c)(2) expressly sets up three specific conditions precedent with which a corporation devoting part of its earnings to the payment of debts rather than the payment of dividends must comply before it is entitled to relief from the tax on undistributed profits—(1) there must be a written contract executed by the corporation prior to May 1, 1936; (2) this contract must contain a provision expressly dealing with the disposition of earnings and profits of the taxable year; and, (3) this contract must contain a provision requiring that a portion of such earnings and profits either (a) "be paid within the taxable year in discharge of a debt", or (b) "be irrevocably set aside within the taxable year for the discharge of a debt". A taxpayer whose contract satisfies each of these three requirements is entitled to a credit to the extent of the amount which has been so paid or irrevocably set aside.

While taxpayers have met the first two statutory requirements —the written contracts antedate May 1, 1936, and contain provisions expressly dealing with the disposition of earnings for the taxable year—, they have not met the third one.[6] The con-

[4] An opinion was written only in Commissioner v. Strong Mfg. Co., 124 F. 2d 360. The other two cases were per curiam affirmances on the authority of that opinion. 124 F. 2d 397.

[5] Compare Helvering v. Moloney Electric Co., 120 F. 2d 617, 621.

tracts clearly contain no provision requiring the payment of earnings "within the taxable year in discharge of a debt". Nor do they, contrary to taxpayers' assertion, require the irrevocable setting aside of earnings "within the taxable year for the discharge of a debt" within the meaning of § 26(c)(2). The contracts are wholly silent in respect of any setting aside; they do not in terms require taxpayers to set aside the amount due, nor do they direct any segregation or physical retention whatsoever. The only requirement is that taxpayers pay on or before a date *after* the close of the taxable year. This is not enough. Until that date taxpayers were free to use the specified percentages as they pleased, so far as the agreements were concerned. That prudent business judgment, or the possibility of fiduciary liability imposed by operation of law might have constrained taxpayers to refrain from using these percentages and actually to set them aside is immaterial; such setting aside was not required by the terms of the written contracts, and therefore did not satisfy § 26(c)(2). Cf. *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 52. Likewise the fact that taxpayers actually irrevocably set the funds aside by anticipatory payments within the taxable year is of no moment, because these payments were voluntary and not pursuant to the command of the agreements.

That Congress did not intend that the statutory condition of an irrevocable setting aside would be satisfied by a contract which, without more, merely requires that a percentage of earnings of the taxable year be paid in some future year for the discharge of a debt, is evident because such a construction reduces the alternative condition of § 26(c)(2) relating to actual payment within the taxable year to a meaningless superfluity. The date specified for payment would become immaterial for all purposes if the mere requirement by contract of future payment out of earnings in a given year automatically entails an "irrevocable setting aside" within that year.

Taxpayers here place great emphasis upon the different prepositions used in the alternative phrases—"to be paid within the taxable year *in* discharge of a debt" or to be irrevocably set aside

[6] This holding makes it unnecessary to consider the Commissioner's contention that The Strong Manufacturing Company did not meet the second requirement as to $5,000 of the $46,500 paid in 1936, because it was obligated to pay that sum by April 15, 1937, even in the event that there were no earnings in 1936.

within the taxable year *for* the discharge of a debt''— to show that payment may be made after the taxable year compatibly with § 26(c)(2). True enough, payment can be postponed to a future year and a credit allowed if, but only if, the contract directing such future payments requires in terms the irrevocable setting aside within the taxable year of those future payments. The instant contracts do not so provide.

Respondents, The Ohio Leather Company and Warren Tool Corporation, contend that because they were on an accrual basis of accounting, they were entitled to the credit by virtue of § 43[7] which states that it is to be disregarded in computing the credit provided by § 27 and makes no statement with regard to § 26. The contention is without merit because principles of accrual accounting have no bearing on the question of whether a contract in terms requires a payment or an irrevocable setting aside within the taxable year. The question here is not whether taxpayers made payment, either on a cash or an accrual basis, within the taxable year, but whether their contracts required them to pay or irrevocably set aside within the taxable year.

Taxpayers insist that it would be unreasonable to hold that only contracts expressly requiring payment or an irrevocable setting aside of a percentage of earnings within the taxable year satisfy § 26(c)(2) because many corporations are unable to determine their earnings until after the close of their fiscal year, and consequently their contracts disposing of a percentage of earnings in satisfaction of debt customarily allow some short period after the close of the year before payment is required. The legislative history of the 1936 Act reveals that Congress was conversant with the problem of computing earnings before the end of the taxable year, in connection with dividend payments, but declined to act.[8] Corporations with oral contracts, or written contracts executed after May 1, 1936, dealing with the disposition of profits in satisfaction of debts also probably think § 26(c)(2) is a most unreasonable statute. But arguments urging the broadening of a tax deduction statute beyond its plain mean-

[7] Sec. 43. Period for Which Deductions and Credits Taken.
The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which ''paid or accrued'' or ''paid or incurred'', dependent upon the method of accounting upon the basis of which the net income is computed, ...''

[8] The original House bill (H. R. 12395, 74th Cong., 2d Sess., introduced at 80 Cong. Rec. 5978) provided for the use of the ''dividend year'' in com-

ing to avoid harsh results are more properly addressed to Congress than to the courts. *White* v. *United States*, 305 U. S. 281, 292.[9]

Finally taxpayers contend that the legislative history of § 26(c)(2) supports the view that their contracts are covered by that section. An examination of the entire legislative background of the undistributed profits tax demonstrates, contrary to taxpayers' contentions, that Congress intended the tax to be imposed primarily upon income not distributed in the form of dividends, rather than only upon corporate income which was not distributed at all and accordingly meant to limit severely credits for a corporation's payment of debts and precisely to define the area in which taxpayers were to be entitled to the credit. Thus, while the original House bill contained complicated provisions affording some relief to corporations with deficits, or contractually obligated either to pay debts or not to pay dividends, the Senate Finance Committee struck them all out, substituting only a provision dealing with a credit for contractual prohibitions against the payment of dividends.[10] An amendment offered from the Senate floor giving a broad credit for all portions of adjusted net income used to purchase or replace machinery, equipment, etc., or "expended or applied during the taxable year for the liquidation, payment, or reduction of the principal of any bona-fide indebtedness outstanding at the date of enactment of this Act" was rejected.[11]

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puting undistributed net income under § 13, and dividend credit under § 15. Section 27 defined "dividend year" as the period beginning on the 15th day of the third month after the day before the beginning of the taxable year and ending on the 14th day of the third month after the close of the taxable year. Thus, where the calendar year and the taxable year coincided, the "dividend year" would cover the period from March 15 of the taxable year to March 14 of the following year. Congressman Hill, chairman of the subcommittee of the House Ways and Means Committee, explained that the "dividend year" was designed to allow corporations time to cast up their accounts after the close of the taxable year and then determine what dividends should be distributed. 80 Cong. Rec. 6005. Nevertheless, Congressman Hill later offered, and the House adopted, a committee amendment substituting the "taxable year" for the "dividend year". 80 Cong. Rec. 6308. See also 80 Cong. Rec. 10265.

[9] Appeals to Congress because of the limited scope of § 26(c)(2) were successful in 1938. Section 27(a)(4) of the Revenue Act of 1938 allows a credit without reference to the particular terms or requirements of the indebtedness. See H. Rep. No. 1860, 75th Cong., 3d Sess., p. 4.

[10] This legislative history is discussed in Helvering v. Northwest Steel Mills, 311 U. S. 46, 50.

[11] 80 Cong. Rec. 9055, 9070, 74th Cong., 2d Sess.

The much narrower amendment which became §.26(c)(2) was then offered with little explanation other than that it was intended to supplement the credit for contractual prohibition against dividend payments, the provision which became § 26(c)(1).[12]

We conclude that the judgments below were erroneous. Accordingly they are reversed, and the causes remanded with directions to uphold the determination of the Commissioner.

Reversed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

[12] 80 Cong. Rec. 9071, 74th Cong., 2d Sess.